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American Institute of Certified Public Accountants. Control Risk Audit Guide Task Force

EXPOSURE DRAFT

PROPOSED AUDIT AND ACCOUNTING GUIDE FOR CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN A FINANCIAL STATEMENT AUDIT

AUGUST 21, 1989

**Prepared by the Control Risk Audit Guide Task Force,
Auditing Standards Division,
American Institute of Certified Public Accountants**

**Comments should be received by November 10, 1989, and addressed to
Mimi Blanco-Best, Technical Manager, Auditing Standards Division, File 3046
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036-8775**

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AICPA American Institute of Certified Public Accountants

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August 21, 1989

Accompanying this letter is an exposure draft of a proposed AICPA audit guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, prepared by the Control Risk Audit Guide Task Force. A summary of the proposed guide also accompanies this letter.

The purpose of this exposure draft is to solicit comments from auditors and other interested parties. It was developed to assist auditors by illustrating how SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, might be applied in certain situations.

In developing this guidance, the task force considered the relationship between the cost that would be incurred and the benefits reasonably expected to be derived in audits. It also considered differences the auditor may encounter in the audit of the financial statements of small entities and, when appropriate, made special provisions to meet those needs. Thus, the task force would particularly appreciate comments on those matters.

Throughout the text, passages from authoritative pronouncements (mainly SAS No. 55) have been underlined to assist you in your review. Therefore, please focus your comments and suggestions on the illustrative guidance in this proposed guide rather than on these underlined authoritative passages. Written comments should be addressed to Mimi Blanco-Best, AICPA, Auditing Standards Division, 1211 Avenue of the Americas, New York, N.Y. 10036, in time to be received by November 10, 1989.

Written comments on the exposure draft will be included in the public record of the AICPA and will be available for public inspection at its offices for one year after December 15, 1989.

Sincerely,

Barry Barber
Co-Chairman
Control Risk Audit Guide Task Force

Richard M. Steinberg
Co-Chairman
Control Risk Audit Guide Task Force

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
- *Sampling of members in industry and education.*
- *Members of AICPA Council and technical committee chairmen.*
- *State society and chapter presidents, directors, and committee chairmen.*
- *Organizations concerned with regulatory, supervisory, or other public disclosures of financial activities.*
- *Persons who have requested copies.*

SUMMARY

In February 1988, the Auditing Standards Board issued SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. SAS No. 55 requires that, in every audit, the auditor --

- Obtain an understanding of each of the elements (control environment, accounting system, and control procedures) of the internal control structure sufficient to plan the audit, and
- Assess control risk for assertions related to account balances and transaction classes.

This proposed guide was prepared to illustrate how SAS No. 55 might be applied by auditors in certain situations.

Specifically, this proposed guide does this by illustrating two different audit strategies among many that an auditor might choose when auditing an assertion. As depicted in the flowchart in figure 1-2, the auditor may plan --

- A primarily substantive approach (which ordinarily results in a control risk assessment at or slightly below maximum), or
- A lower control risk assessment.

In each case, the preliminary audit strategy may influence the extent of understanding of each element of the internal control structure that the auditor needs to obtain. Therefore, the nature, timing, and extent of procedures performed to obtain this understanding and assess control risk may differ. The audit strategy may also affect the nature, timing, and extent of substantive procedures to be performed.

This proposed guide provides guidance on these matters as well as on the related documentation of evidence obtained by the auditor. It supports the guidance with illustrations of the audits of three hypothetical companies -- Ownco, Inc., Young Fashions, Inc., and Vinco, Inc. Ownco, Inc. is a small, owner-managed business. Young Fashions, Inc. represents a growing, nonpublic company with multiple locations. Vinco, Inc. is a large public company. Since most accounting systems involve computer processing (through a microcomputer, minicomputer, or mainframe), each of these three hypothetical companies uses some form of computer processing. Through these illustrations, presented in *italics* throughout, the proposed guide describes how an auditor's procedures to obtain the understanding and assess control risk may differ from audit to audit.

Control Risk Audit Guide Task Force
(1989)

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CHAPTER 1

OVERVIEW OF STATEMENT ON AUDITING STANDARDS NO. 55, *CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE IN A FINANCIAL STATEMENT AUDIT*

1.1 The second standard of fieldwork is defined in SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as follows:

> A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

This chapter provides an overview of the second standard of fieldwork and SAS No. 55. It presents the elements of the internal control structure and highlights the auditor's responsibilities for understanding an entity's internal control structure, assessing control risk, and designing substantive tests. The final section of this chapter provides an overview of the remainder of this proposed audit guide.

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

1.2 An entity's internal control structure comprises the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. Generally, the policies and procedures that are relevant to an audit pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements. For a financial statement audit, an entity's internal control structure comprises the control environment, the accounting system, and control procedures. These elements of the internal control structure are described in figure 1-1.

UNDERSTANDING THE INTERNAL CONTROL STRUCTURE

1.3 SAS No. 55 requires the auditor to obtain a sufficient understanding of the control environment, the accounting system, and control procedures to plan the audit. This understanding of the internal control structure elements should be used to --

FIGURE 1-1

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

For a financial statement audit, an entity's internal control structure comprises the following:

Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies or procedures. The control environment includes such factors as—

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

The control environment reflects the overall attitude, awareness, and action of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Control Procedures: Those policies and procedures, in addition to the control environment and the accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparisons of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

- o Identify types of potential misstatements.
- o Consider factors that affect the risk of material misstatement[1]
- o Design substantive tests.

1.4 The level of understanding of each element that the auditor should obtain varies based on --

- o The complexity and sophistication of the entity's operations and systems.
- o The auditor's previous experience with the entity.
- o The assessment of inherent risk (that is, the susceptibility to material misstatement).
- o The auditor's understanding of the particular industry.
- o The auditor's judgment about materiality.
- o The preliminary audit strategy.

CONTROL ENVIRONMENT

1.5 The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor uses professional judgment in determining which factors, such as those outlined in figure 1-1, are relevant.

ACCOUNTING SYSTEM

1.6 The auditor should obtain sufficient knowledge of the accounting system to understand --

- o The classes of transactions in the entity's operations that are significant to the financial statements.
- o How those transactions are initiated.
- o The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.

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1 Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

- o The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.

- o The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

CONTROL PROCEDURES

1.7 SAS No. 55 recognizes that, as the auditor obtains an understanding of the control environment and accounting system, he or she will most likely gain knowledge about some control procedures as well (for example, an auditor who learns a client's inventory accounting system also learns the client's procedures for taking physical inventories). In some audits, this knowledge of control procedures may be sufficient to plan a primarily substantive approach. In other audits, the auditor may need to devote additional effort to understanding the control procedures. Ordinarily, audit planning does not require an understanding of control procedures related to each account balance, transaction class, or disclosure component in the financial statements or to every assertion relevant to those components.

PROCEDURES TO OBTAIN THE UNDERSTANDING

1.8 In performing procedures to obtain an understanding of the internal control structure, the auditor should determine how internal control structure policies and procedures are *designed* and whether they have been *placed in operation*. *Design* is concerned with whether a policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. *Placed in operation* means that the policy or procedure actually exists and is in use.

1.9 The auditor often obtains this knowledge through previous experience with the entity and procedures such as --

- o Inquiries of appropriate management, supervisory, and staff personnel.

- o Inspection of documents and records.

- o Observation of an entity's activities and operations.

1.10 The nature and extent of procedures the auditor chooses to perform to obtain the understanding will vary depending on the size and complexity of the entity, previous experience with the entity, the nature of the particular policy or procedure involved, and the nature of the entity's documentation of specific policies and procedures.

DOCUMENTING THE UNDERSTANDING

1.11 SAS No. 55 requires auditors to document their understanding of the internal control structure. The form and extent of documentation is flexible. Generally, the more complex an entity's internal control structure and the more extensive the procedures performed to obtain the understanding,

the more extensive the auditor's documentation should be. For example, in a small, owner-managed entity, the auditor may document his or her understanding of the control environment or the accounting system and control procedures in the form of a memorandum. On the other hand, for an entity with a complex computer system, the auditor may use questionnaires or flowcharts.

ASSESSING CONTROL RISK

1.12 *Control risk* is the risk that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures. *Assessing control risk* is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions (existence or occurrence, completeness, rights and obligations, valuation or allocation, presentation and disclosure). The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk. This level may vary along a range from maximum to minimum[2] as long as the auditor has obtained evidential matter to support an assessment below maximum.

1.13 An auditor may assess control risk for some or all assertions at the maximum because *a)* policies or procedures are not relevant to an assertion, *b)* they are not effective or are unlikely to be effective, or *c)* testing their effectiveness would be inefficient.

1.14 To assess control risk below the maximum, the auditor should --

- Identify specific internal control structure policies or procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.

- Perform tests of controls to evaluate the effectiveness of such policies or procedures.

1.15 Tests of controls are directed toward the evaluation of the effectiveness of the design and operation of internal control structure policies and procedures. Tests of controls directed toward the

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2 This proposed audit guide uses terms such as *at the maximum, slightly below the maximum, moderate,* and *low* for illustration purposes to describe assessments of control risk. SAS No. 55 does not require the use of such terms and indicates that control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. SAS No. 55 only requires the auditor to document the basis for his or her assessment of control risk below the maximum. The auditor does not have to state the degree to which control risk is assessed below the maximum (see chapter 4, paragraph 4.9).

effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. Internal control structure policies or procedures can be either directly or indirectly related to an assertion. The more direct the relationship, the more effective that policy or procedure may be in reducing control risk for an assertion.

1.16 Tests of controls ordinarily include the following procedures:

- o Inquiries of appropriate entity personnel
- o Inspection of documents and reports
- o Observation of the application of specific internal control structure policies and procedures
- o Reperformance of the application of the policy or procedure by the auditor

1.17 Evidence about the effectiveness of design and operation of internal control structure policies and procedures may be obtained through --

- o Procedures performed while obtaining the understanding that may serve as tests of controls.
- o Planned tests of controls to support a lower assessed level of control risk.

EVIDENCE FROM THE UNDERSTANDING

1.18 SAS No. 55 does not require auditors to gain knowledge of the effectiveness of design and operation of internal control structure policies or procedures when obtaining the understanding. However, it does require auditors to obtain evidence about effective design and operation of policies and procedures to assess control risk below the maximum. Procedures performed to obtain the understanding may provide knowledge of the effectiveness of the internal control structure. These procedures may serve as tests of controls and may be sufficient to support an assessed level of control risk below the maximum.

1.19 However, caution is necessary. Audit procedures performed in obtaining the understanding cannot support an assessment of control risk below the maximum unless they provide evidence about the effectiveness of the design and operation of internal control policies and procedures. In addition, the auditor's procedures may not be extensive and may only support a control risk assessment of slightly below the maximum.

PLANNED TESTS OF CONTROLS

1.20 For some assertions, the auditor may plan and perform tests of controls to support a lower assessed level of control risk. These tests of controls are designed to provide more evidence about the effectiveness of the design and operation of relevant internal control structure policies and procedures than that which the auditor may obtain from procedures performed to obtain the understanding as discussed in paragraphs 1.18 and 1.19. Such tests may be performed concurrently with obtaining an understanding or at a subsequent date.

RECONSIDERING THE PRELIMINARY AUDIT STRATEGY

1.21 During the audit, the auditor may conclude that it would be efficient and that evidence is likely to be available to support a further reduction in the assessed level of control risk for some assertions (particularly for assertions for which the auditor performed no tests of controls or for which the auditor performed tests while obtaining an understanding sufficient to plan a primarily substantive approach). For these assertions, the auditor should perform additional tests of controls to support a further reduction in the assessed level of control risk. This might also involve obtaining a more extensive understanding of the internal control structure.

1.22 The assessed level of control risk should be consistent with the degree of assurance from evidence provided by tests of controls. That is, the lower the assessed level of control risk for an assertion, the more assurance is needed from evidence about the operating effectiveness of policies and procedures relevant to the assertion. If the evidence (that is, results of tests of controls) does not support the planned assessed level of control risk, the auditor should assess control risk higher than planned and revise the preliminary audit strategy.

DOCUMENTING THE CONTROL RISK ASSESSMENT

1.23 When the auditor concludes that control risk is at the maximum, SAS No. 55 requires that only the conclusion itself be documented. The auditor does not need to document the basis for that conclusion.

1.24 Where the assessed level of control risk is below the maximum, SAS No. 55 requires the auditor to document the basis for conclusions. Documentation of the basis for assessment should be evidenced by tests of controls applied to internal control structure policies and procedures and their results. The auditor is not required to document how far below the maximum control risk is assessed. However, the auditor may document the assessed level of control risk in quantitative terms (such as percentages) or in qualitative terms (such as slightly below the maximum, moderate, or low).

EFFECT OF THE ASSESSED LEVEL OF CONTROL RISK ON SUBSTANTIVE TESTS

1.25 The assessed level of control risk for an assertion has a direct effect on the design of substantive tests. The lower the assessed level of control risk, the less evidence the auditor needs from substantive tests to form an opinion on the financial statements. Consequently, as the assessed

level of control risk decreases, the auditor may modify substantive tests by --

- Changing the nature of substantive tests from a more effective to a less effective test, such as using tests directed toward parties within rather than outside the entity.

- Changing the timing of substantive tests, such as performing them at an interim date rather than at year end.

- Changing the extent of substantive tests, such as selection of a smaller sample size.

Ordinarily, the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

OVERVIEW OF THE GUIDE

1.26 A flowchart of the auditor's consideration of the internal control structure and its relation to substantive tests for some or all assertions is presented in figure 1-2 to provide an outline of this proposed audit guide. This flowchart recognizes that auditors often adopt a preliminary audit strategy that influences the extent of understanding of the internal control structure and design of tests of controls and substantive tests. It presents the two following strategies that may be used for different assertions:

- *Obtaining an understanding sufficient to plan a primarily substantive approach.* This strategy ordinarily results in an assessment of control risk at or slightly below maximum. However, if procedures performed in obtaining the understanding also provide evidence about the effective design and operation of internal control structure policies or procedures, they may serve as tests of controls. In this case, the auditor could reconsider the preliminary audit strategy and perform additional tests of controls to obtain additional evidential matter sufficient to support a further reduction in the assessed level of control risk (see page 2 of the flowchart).

- *Obtaining an understanding of the internal control structure and planning to perform tests of controls sufficient to support a lower control risk assessment.*

Explanations and examples of these two strategies are presented in the remaining chapters of this proposed audit guide.

FIGURE 1-2

FLOWCHART OF THE AUDITOR'S CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS

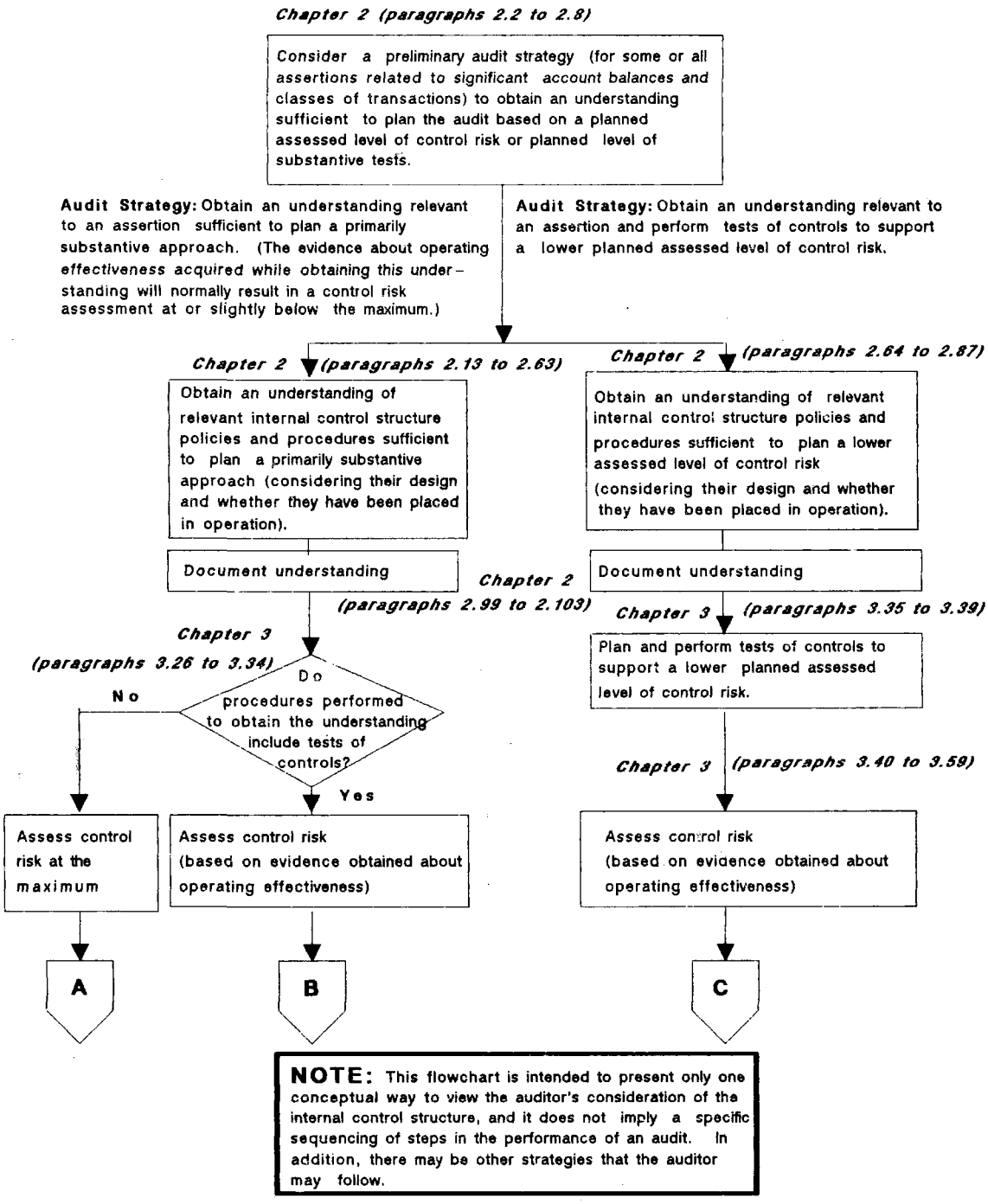
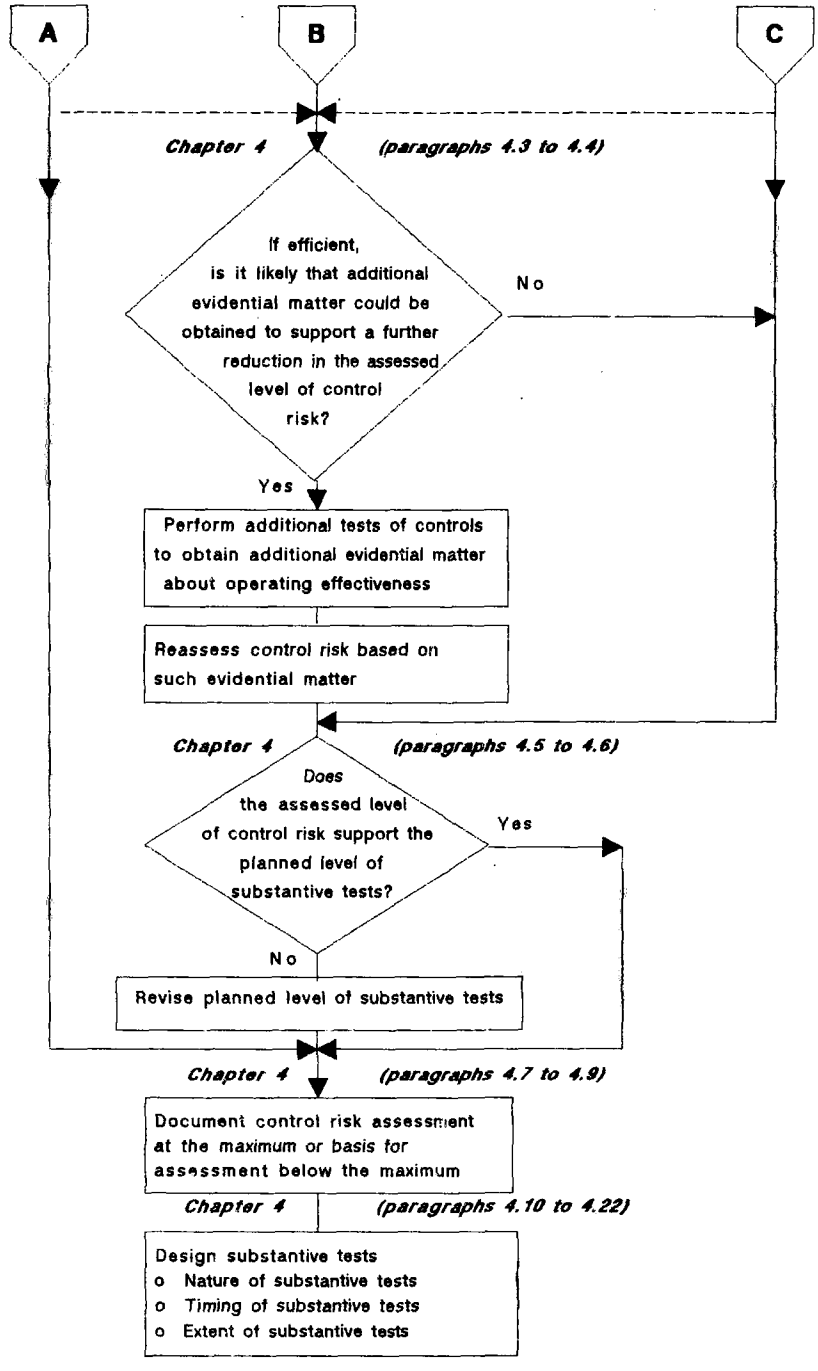


FIGURE 1-2
(Cont.)



1.27 Chapter 2 explains *a)* the development of a preliminary audit strategy and *b)* the auditor's understanding of the internal control structure under each strategy. Chapter 2 also explains the required documentation of the auditor's understanding of the internal control structure.

1.28 Chapter 3 discusses *a)* the auditor's assessment of control risk based on the procedures performed to obtain the understanding of the internal control structure, *b)* how the procedures performed to obtain the understanding may be tests of controls, and *c)* the degree of assurance provided by such tests. Chapter 3 then discusses the auditor's tests of controls to support a lower assessed level of control risk and provides examples of planned tests of controls related to a lower control risk assessment.

1.29 Chapter 4 discusses decisions to reconsider the preliminary audit strategy, either by considering a further reduction in the assessed level of control risk or by considering revisions to planned substantive tests because evidential matter did not support the planned substantive tests. Chapter 4 also discusses and provides examples of the documentation of the auditor's control risk assessment, and how conclusions about assessing control risk at the maximum, or below the maximum, affect the auditor's decisions about the nature, timing, and extent of substantive tests.

1.30 Chapter 4 is followed by a series of exhibits that provide example workpaper documentation of the understanding of the internal control structure, of tests of controls, and of the auditor's control risk assessment.

1.31 A series of appendices supplement this proposed audit guide. Appendix A discusses other Statements on Auditing Standards with which the auditor should be familiar to understand the second standard of fieldwork. It provides a perspective on the preliminary audit strategy and on the relationship of the auditor's consideration of the internal control structure to other audit considerations. Appendix B compares the requirements of SAS No. 55 with those of the previous professional literature. Appendix C provides a reprint of SAS No. 55.

CHAPTER 2

UNDERSTANDING THE INTERNAL CONTROL STRUCTURE

2.1 This chapter discusses --

- o The auditor's preliminary audit strategy.
- o The nature of the auditor's understanding: design and placed in operation.
- o The understanding of the internal control structure sufficient to plan a primarily substantive approach.
- o The understanding of the internal control structure sufficient to plan a lower control risk assessment.
- o The nature and extent of procedures performed to obtain the understanding.
- o Documentation of the understanding.

PRELIMINARY AUDIT STRATEGY

2.2 Figure 2-1 presents the flowchart that was introduced in chapter 1 and highlights the sections relating to the auditor's preliminary audit strategy. The auditor's ultimate objective in planning and performing a financial statement audit is to reduce audit risk to an appropriately low level to express an opinion on whether such financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles.[1] Because of the interrelationships between inherent risk, control risk, and detection risk, the auditor often will be able to choose between several possible audit approaches to audit an assertion applicable to a material account balance or transaction class. When considering a preliminary audit strategy for some or all assertions, the auditor considers knowledge of the entity's business, the industry in which it operates, the nature and materiality of different account balances, prior experience with the industry, and other factors. The auditor then makes an overall judgment about the audit approach that will reduce audit risk to an appropriately low level.

2.3 The preliminary audit strategy is not a detailed design of audit procedures. Rather, it represents preliminary judgments about an audit

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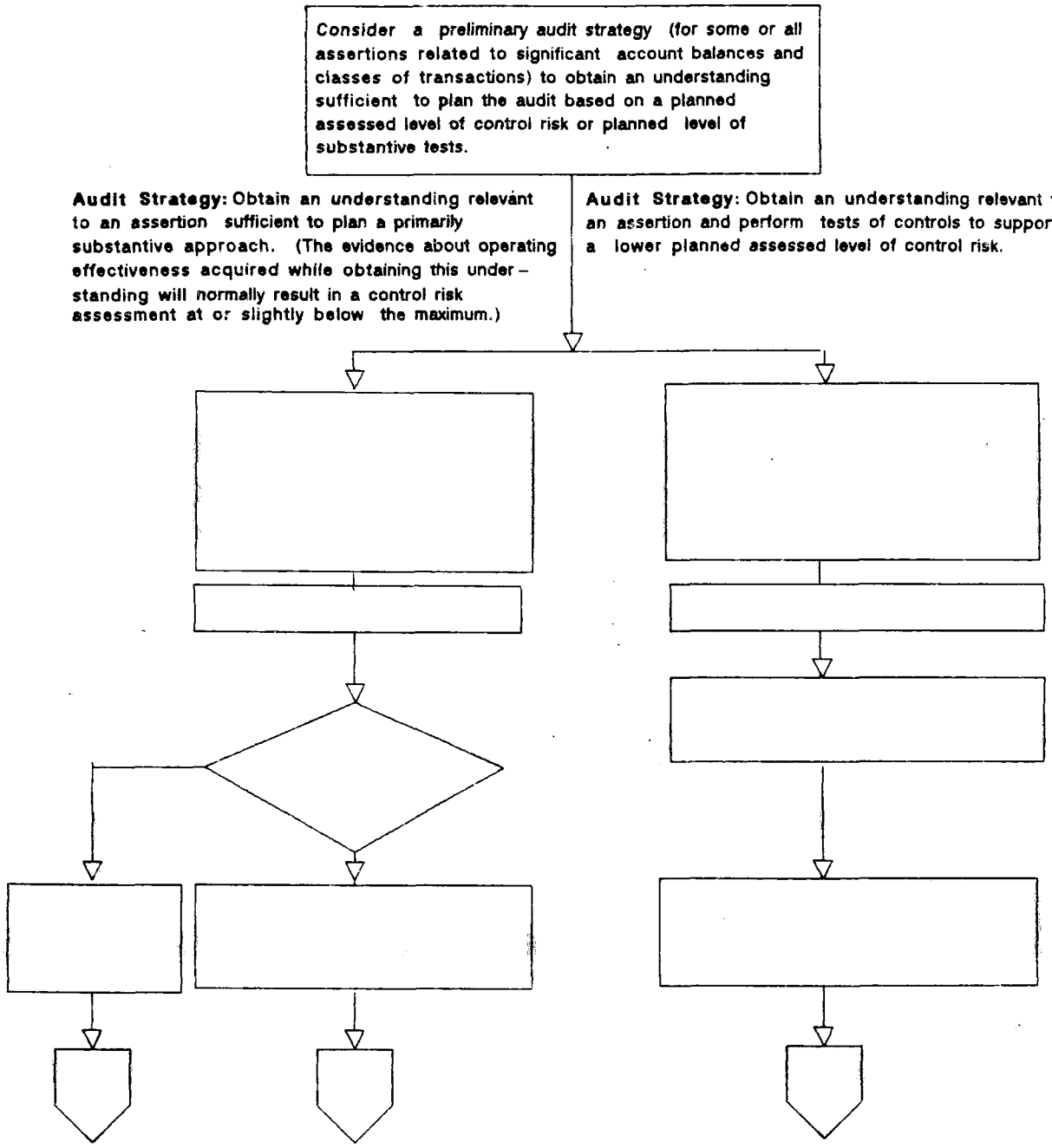
1 The guidance provided in this proposed audit guide applies to audits of financial statements prepared either in accordance with generally accepted accounting principles or in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

FIGURE 2-1

FLOWCHART OF THE AUDITOR'S CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



approach that are updated as necessary during the conduct of the audit as the auditor confirms initial judgments or obtains evidence to the contrary.

2.4 A preliminary audit strategy may reflect --

- o The planned assessed level of control risk.
- o The extent of the understanding of the internal control structure.
- o Tests of controls that may be performed (including procedures to obtain the understanding).
- o The planned level of substantive tests to be performed to reduce audit risk to an appropriately low level, considering the planned assessed level of control risk.

2.5 For example, developing a preliminary audit strategy involves considering whether computer-produced records, such as an accounts receivable aged trial balance, will be used as evidential matter to support an assertion. The auditor may test the computer-produced information by either --

- o Testing the report substantively, or
- o Understanding the computer control procedures that are intended to ensure the completeness and accuracy of such reports and performing tests of controls to assess the effective design and operation of such control procedures.

2.6 The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit of the entity's financial statements. An understanding of internal control structure policies and procedures is necessary, regardless of the auditor's preliminary audit strategy for an assertion. In planning the audit, such knowledge should be used to --

- o Identify types of potential misstatements.
- o Consider factors that affect the risk of material misstatements.
- o Design substantive tests.

2.7 In making a judgment about the nature and extent of the understanding needed to plan the audit, the auditor considers the following:

- o Knowledge from previous audits
- o The understanding of the industry in which the entity operates
- o Assessments of inherent risk
- o Judgments about materiality
- o The complexity and sophistication of the entity's operations and systems (including whether the method of controlling data processing

is based on manual procedures independent of the computer or is highly dependent on computerized control procedures)

As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control structure elements to obtain the understanding of them that is necessary to design effective substantive tests. Discussing each of the internal control structure elements separately facilitates discussion of their nature and how the auditor considers these elements in obtaining the necessary understanding. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category.

2.8 The level of understanding of the internal control structure needed under the two preliminary audit strategies presented in figure 1-2 may be different. Figure 2-2 expands on elements of the internal control structure the auditor needs to understand each strategy. To illustrate the application of these preliminary audit strategies, three sample companies are presented in the exhibits following chapter 4. Ownco, Inc., represents a small, one-location, owner-managed business that does not have a complex organizational structure or a sophisticated operation or computer system. Young Fashions, Inc., represents a growing, nonpublic company with multiple locations. Company goals have focused on operations, and the accounting systems have not grown at the same pace as the organization. For these two companies, the auditor planned to assess control risk based only on the procedures performed to obtain the understanding sufficient to plan a primarily substantive approach that may serve as tests of controls. A more complex public company, Vinco, Inc., is also presented. For audit efficiency reasons, the Vinco auditor has chosen to understand and test sufficient internal control structure policies and procedures to support a lower assessed level of control risk for some assertions. See exhibits A-1 and A-2 for further background on these three companies. *Italics are used in the remainder of this proposed audit guide when discussing the examples relating to these companies.*

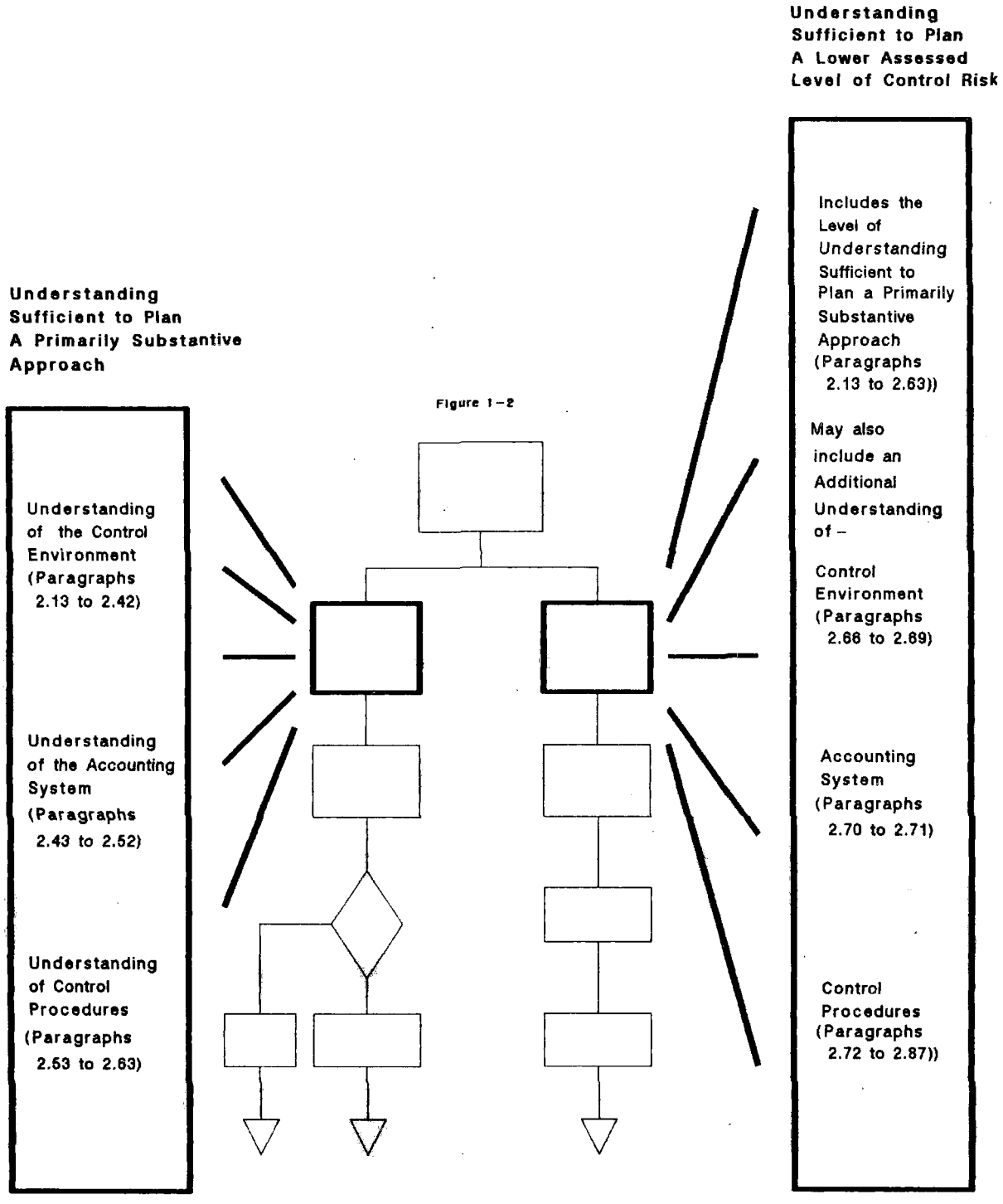
NATURE OF THE AUDITOR'S UNDERSTANDING: DESIGN AND PLACED IN OPERATION

2.9 The understanding of the internal control structure should include knowledge about the design of relevant policies, procedures, and records, and whether they have been placed in operation by the entity.

2.10 The auditor's knowledge about the *design* of relevant policies, procedures, or records provides an indication of the types of potential misstatements and the risk that such misstatements may be material. For example, an entity may not have any policies or procedures relating to the qualifications or training of accounting personnel (inadequate design). This lack of policies or procedures may allow the entity to hire unqualified personnel, which may affect the risk of material misstatement. In contrast, an entity may have a procedure for the monthly reconciliations of its bank accounts. This procedure ordinarily is designed to detect and correct misstatements in the existence and completeness assertions for cash receipts, cash disbursements, and related account balances. However, if the design of the entity's procedure does not include adequate follow-up on reconciling items or a supervisory review, the risk of misstatements

FIGURE 2-2

UNDERSTANDING THE INTERNAL CONTROL STRUCTURE



occurring and going uncorrected is affected. Risks such as these are caused by the poor design of the internal control structure and should be considered by the auditor when designing substantive tests.

2.11 In obtaining knowledge about whether policies, procedures, or records have been placed in operation, the auditor should determine that the entity is using them. In other words, the policy or procedure is not solely part of a policy manual or other entity documentation; it has been implemented. For example, an entity may have designed a computer program and data-input procedures for preparation of customer invoices but may not yet have begun using the new program.

2.12 Whether an internal control structure policy or procedure has been placed in operation is different from its *operating effectiveness.* Operating effectiveness is concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. Auditing standards do not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure. However, if procedures performed to obtain the understanding provide some evidence about the effectiveness of design and operation, they may serve as tests of controls (see chapter 3).

UNDERSTANDING SUFFICIENT TO PLAN A PRIMARILY SUBSTANTIVE APPROACH

2.13 Figure 2-3 presents the flowchart that was introduced in chapter 1 and highlights the material covered in this section. One audit strategy that the auditor may consider when auditing an assertion involves --

- Obtaining the understanding sufficient to plan a primarily substantive approach; and
- Considering whether procedures performed during this process serve as tests of controls that provide evidential matter about operating effectiveness.

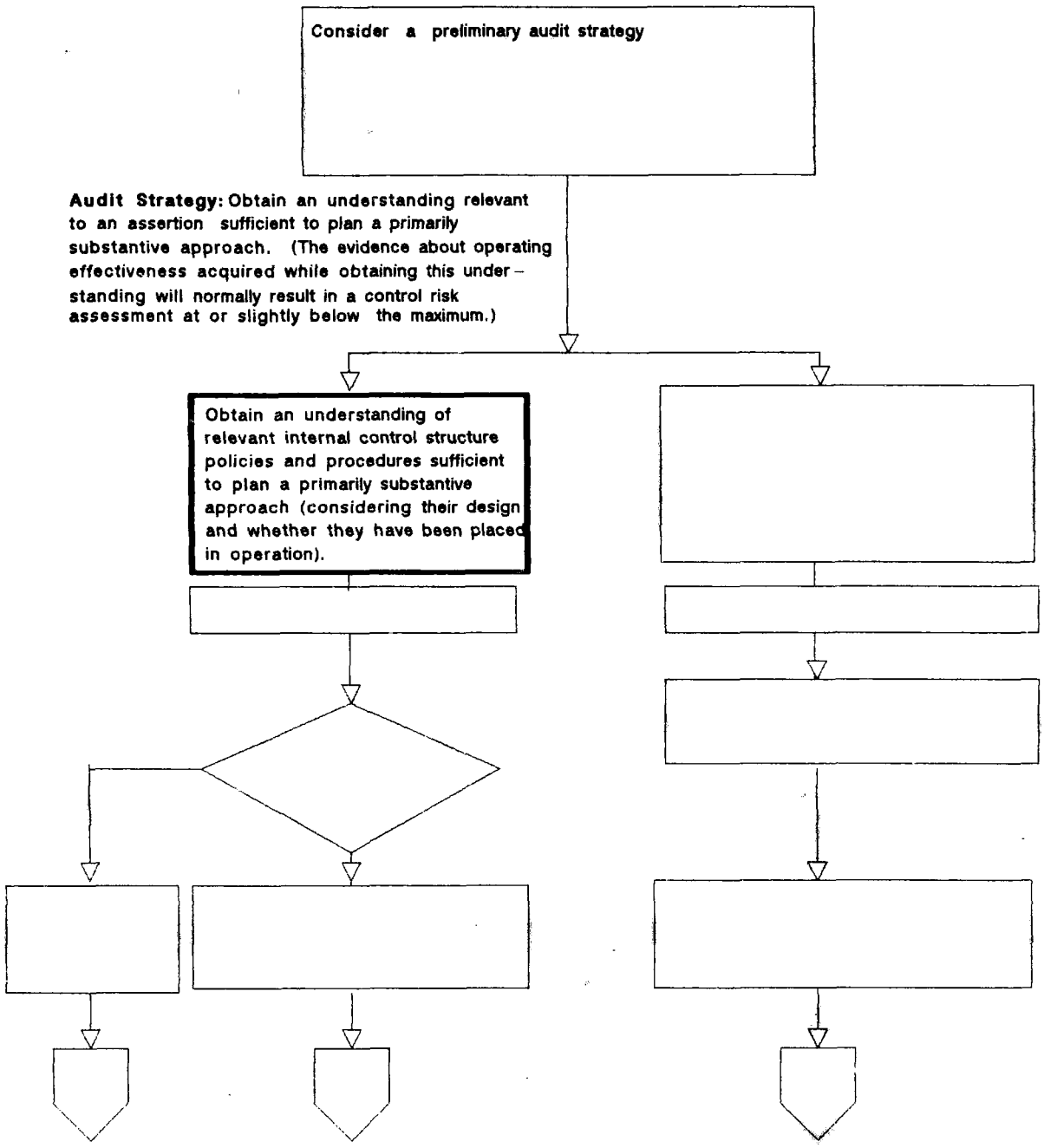
The procedures performed to obtain this level of understanding may serve as tests of controls and normally support a control risk assessment at or slightly below maximum (see chapter 3).

2.14 Designing effective audit procedures requires that the auditor have a sufficient understanding of the internal control structure to assess the risk of material misstatement. Knowledge of control environment factors, the specific methods of initiating, processing, recording, and reporting transactions, and methods of controlling this processing, assist the auditor in the design of effective audit procedures. For example, the following factors identified while understanding the internal control structure may have an effect on the risk of misstated revenues:

- Management pressure to improve operating performance
- Numerical sequence of shipping documents not accounted for
- Unrestricted access to input terminals

FIGURE 2-3

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



By understanding these risk factors, the auditor can design appropriate substantive tests.

2.15 The auditor has obtained the necessary understanding when the risk of material misstatement for assertions related to material financial statement components can be assessed and effective substantive procedures can be designed. Obtaining an understanding sufficient to plan a primarily substantive approach does not contemplate understanding the internal control structure policies and procedures that might be necessary to assess control risk at a lower level. (See paragraphs 2.64 to 2.87 for a discussion of the understanding to support a lower assessed level of control risk.) Paragraphs 2.16 through 2.63 provide guidance on the nature and extent of the understanding of the internal control structure considered sufficient to plan a primarily substantive approach.

UNDERSTANDING OF THE CONTROL ENVIRONMENT

2.16 The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The control environment includes such factors as --

- o Management's philosophy and operating style.
- o The entity's organizational structure.
- o The functioning of the board of directors and its committees, particularly the audit committee.
- o Methods of assigning authority and responsibility.
- o Management's control methods for monitoring and following up on performance.
- o Internal auditing.
- o Personnel policies and practices.
- o Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

2.17 The applicability and importance of these factors is affected by the entity's size and its organization and ownership characteristics. Paragraphs 2.21 to 2.42 provide examples of how the control environment may affect the risk of material misstatement and of how the extent of the auditor's understanding of the control environment may vary depending on the complexity and sophistication of the entity. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but not act on them.

2.18 The auditor should understand the collective effect of the control environment factors discussed in the following paragraphs as they relate to

management's attitude, awareness, and actions concerning the control environment. However, the auditor does not need to understand each factor in every case or to the same degree of detail. The extent of understanding of various control environment factors is a matter of professional judgment and is influenced by the considerations discussed in paragraph 2.42. *For example, the data processing aspects of the control environment of Young Fashions, Inc. are considerably more sophisticated and complex than those of Ownco. The dispersion of authority and decentralization of data-entry points at Young Fashions result in more extensive control environment policies and procedures, such as methods of assigning authority or responsibility and management-control methods. As a result, the Young Fashions auditor obtained a more extensive understanding of relevant control environment factors to plan the audit.*

2.19 The auditor considers the collective effect on the control environment of strengths and weakness in various control environment factors. The overriding factors are usually strengths or weaknesses at high levels of management. For example, good owner-manager control methods may mitigate limited segregation of duties in a small business, or an active and independent board of directors may influence the philosophy and operating style of senior management in larger entities. However, personnel policies directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to maximize earnings.

2.20 An effective control environment interacts with elements of the accounting system and control procedures to help provide reasonable assurance that specific entity objectives are achieved. On the other hand, an ineffective control environment may negate other aspects of the accounting system or control procedures and cause the auditor to assess control risk for some or all assertions higher than he or she otherwise would do.

Management's Philosophy and Operating Style

2.21 Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include management's --

- o Approach to taking and monitoring business risks.
- o Attitudes and actions toward financial reporting.
- o Emphasis on meeting budget, profit, and other financial and operating goals.

For example, the auditor may be concerned about management's unduly aggressive attitude toward financial reporting (management's philosophy and operating style). Not only might this cause the auditor to assess control risk at the maximum for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

These characteristics have a significant influence on the control environment, particularly when management is dominated by one or a few individuals, regardless of the consideration given to the other control environment factors.

2.22 However, a dominant owner-manager does not necessarily cause the auditor to assess control risk at the maximum[2]. *As an owner-managed entity, the management of Ownco is dominated by one individual. Mr. Jones, the owner-manager, demonstrates a positive attitude toward the control environment (exhibit B-1). He exhibits a moderate to conservative attitude toward accepting business risks and is more concerned about taxes than reported earnings. Mr. Jones uses information generated by the accounting system to monitor performance with that of prior years. His review of accounting reports encourages accounting employees to work with greater care, which reduces the risk of material misstatement. Mr. Jones also performs many control procedures, such as checking the accuracy of disbursements and reviewing periodic physical inventories. These factors help to mitigate concerns about the lack of segregation of duties because of limited personnel. Although Mr. Jones is concerned about income taxes, the auditors did not view the possible bias to misstate income as a significant risk because of the otherwise positive control environment.*

2.23 *In Young Fashions, Inc., key decisions are made by a close group of top management that represents a majority of the board of directors (exhibit C-1). Management has been at the forefront of rapid changes in fashion trends; however, this affected the auditor's concerns about the valuation of inventories. Management of Young Fashions closely monitors inventories and operating results. Although management views budgets as objective management tools, it is concerned about growth in reported earnings. Accordingly, this factor may create some pressure or bias toward the overstatement of earnings and, therefore, affected the auditor's concerns about the risk of material misstatement.*

An Entity's Organizational Structure

2.24 An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data-processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

2.25 *Ownco, Inc. is an example of a simple organizational structure (exhibit B-1). The owner-manager dominates a single location enterprise. The owner-manager is responsible for setting and monitoring policy. In this case, Mr. Jones reviews key matters upon his return from an absence. Mr. Jones also is responsible for all key decisions regarding computer processing.*

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2 The auditor usually does not assess control risk for individual elements of the internal control structure. The auditor should consider the combined aspects of the control environment, the accounting system, and control procedures when assessing control risk. Chapters 3 and 4 provide a detailed discussion and examples of the auditor's assessment of control risk.

2.26 *In contrast, Vinco, Inc., is a multi-division public company (exhibit D-1). In this case, the auditor obtained an understanding of the involvement of senior management and outside directors in decision making and in setting the tone of the organization. With multiple operating locations, the auditor also obtained knowledge of the functional responsibilities of the divisions and of the reporting relationships within the entity. Key operating decisions at Vinco, Inc. are centralized with senior management. The auditor also obtained an understanding of the organization of the data processing department, including the reporting relationship of the head of data processing to senior management, and the lines of responsibility within the department.*

The Functioning of the Board of Directors and its Committees, Particularly the Audit Committee

2.27 An active board of directors and audit committee often mitigate concerns relative to risks associated with management's philosophy and operating style by planning and overseeing both business activities and financial reporting. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

2.28 *The board of directors of Ownco, Inc. is composed of family members and does not exert significant influence in monitoring the performance of the owner-manager or the organization (exhibit B-1). The key officers of Young Fashions, Inc. represent a majority of the board of directors, and an audit committee does not exist (exhibit C-1). In Vinco, Inc., however, the board of directors and audit committee have a significant influence on the control environment. Vinco, Inc. has an audit committee composed entirely of outside directors. In addition, the substance of this committee's actions involves regular meetings with both internal and external auditors.*

Methods of Assigning Authority and Responsibility

2.29 These methods affect the understanding of reporting and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of --

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

2.30 *In Ownco, Inc., the owner-manager delegates few significant decisions, which emphasizes the importance of the owner-manager's influence on the control environment. Employee job descriptions are informal. The owner-manager has chosen a computer system that uses purchased software; changes cannot be made to this software.*

2.31 *In Young Fashions, Inc., policies regarding acceptable business practices are largely informal and discussed in new employee orientation. Divisional management participates with key officers in business decision making, but authority primarily rests with senior management. Management pays significant attention to inventory control and closely monitors the sales, production, and shipping aspects of divisional operations. Senior management, however, has delegated authority for data processing decisions to the Data Processing (DP) Manager, who oversees the maintenance of systems documentation and changes to purchased software. The DP Manager also is responsible for computer access and security. Although a formal security policy does not exist, the DP Manager has performed an assessment of sensitive programs and data files and determined that access restrictions are appropriate. The company generally uses vendor-authorized consultants to make system changes; the DP Manager has, on occasion, made simple changes.*

Management's Control Methods for Monitoring and Following Up on Performance

2.32 These methods affect management's direct control over the exercise of authority delegated to others and management's ability to supervise overall company activities. Management control methods include consideration of -

- o Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.

- o Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.

- o Using such methods at appropriate management levels to investigate variances from exceptions and to take appropriate and timely corrective action.

- o Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

2.33 In an owner-managed organization, good owner-manager control may significantly mitigate the effects of the lack of segregation of duties. If an owner-manager monitors performance, reviews bank reconciliations, or carefully reviews and approves disbursements, the risk of misstatements may be significantly reduced. *In Ownco, Inc., Mr. Jones reviews computer-prepared financial statements on a monthly basis and is knowledgeable about the components of operating expenses and how they compare with prior years' amounts (exhibit B-1). Mr. Jones also has consulted with his accountant*

about the purchase of computer software and the appropriate installation of the system.

2.34 *In Young Fashions, Inc., budgets are set informally by key officers and, although variations from budgets are reviewed on a regular basis, management does not extensively document follow-up procedures (exhibit C-1). Data processing management is responsible for establishing and monitoring policies regarding developing and modifying accounting systems and control procedures, including the development, modification, and use of related computer programs and data files. The company primarily uses purchased software and has chosen to use outside consultants for occasional systems changes. Data processing is a small department with primarily operations personnel. As in other areas of the organization, policies are informal and rely on supervision.*

2.35 *Vinco, Inc. represents a company where senior management has concentrated on setting policy and oversees middle management's monitoring of how policies and procedures are implemented (exhibit D-2). Senior management determines the size and nature of investigations from budget that are to be explained, on a timely basis, by lower management. Management also oversees data processing management's role in setting and monitoring policies for systems development and changes, computer operations, and access to programs and data files.*

Internal Audit Function

2.36 The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.

2.37 *Neither Ownco nor Young Fashions have internal audit departments. In Vinco, the auditor obtained an understanding of the above three factors.* The extent to which the auditor obtains an understanding of specific procedures performed by internal auditors is dependent on the auditor's preliminary audit strategy for specific assertions and the audit efficiencies that may be obtained by assessing control risk at a lower level. If the auditor plans a primarily substantive approach and does not plan to use the work of the internal auditors, the auditor need not understand specific work performed by internal auditors.

Personnel Policies and Practices

2.38 These polices and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

2.39 *Ownco, Inc. represents a company with nominal turnover of personnel, and the owner-manager has devoted significant attention to hiring and retaining competent individuals. Mr. Jones believes that hiring experienced personnel is particularly important since there are no layers of supervisory*

personnel and, thus, due to limited segregation of duties, few independent checks of employees' work. Young Fashions, Inc. has established an environment where low wages result in higher turnover and peak-season workloads affect the extent of training and supervision of employees, thereby creating significant time pressures. These personnel policies and procedures may have a significant effect on the risk of material misstatements, particularly for those divisions affected by such personnel problems. All personnel practices for the DP department are the responsibility of the DP Manager, who tries to hire personnel with significant DP experience rather than training entry-level personnel.

External Influences

2.40 External influences are established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory agencies, and review and follow up by parties outside the entity concerned with the entity's actions.

External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations, and prompt management to establish specific internal control structure policies or procedures.

2.41 Examples of the types of external influences that the auditor usually understands are Federal and state bank examiners who review the activities of financial institutions, or lenders who audit accounts receivables pledged as collateral for loans as an oversight function. *Young Fashions, Inc.'s bank loan officer meets regularly with management to monitor the company's financial performance (exhibit C-1). In this instance, the influence of the bank loan officer heightens management's consciousness about taking and monitoring business risks.*

Extent of Understanding of Control Environment Versus Accounting System and Control Procedures

2.42 An entity's accounting system and control procedures are designed to address specific account balances and classes of transactions, whereas an entity's control environment has a pervasive effect on the organization. As a result, the auditor focuses the understanding of the accounting system and control procedures on specific balances and classes. Figure 2-4 presents several accounts for a typical manufacturer that vary significantly in nature, size, and complexity. These characteristics result in differences in the extent of understanding of the accounting system and control procedures that may be needed to plan the audit and are explained in the following sections on the accounting system and control procedures.

UNDERSTANDING OF THE ACCOUNTING SYSTEM

2.43 The accounting system significantly affects the potential for material misstatements, as well as the design of substantive tests. A well-designed accounting system that is placed in operation and operating effectively can provide reliable accounting data and prevent or detect misstatements that otherwise could occur. On the other hand, a poorly designed accounting

FIGURE 2-4

UNDERSTANDING OF INTERNAL CONTROL STRUCTURE

Account Balance (Transaction Class)	*Example Account Characteristics*	*Extent of Understanding That May Be Needed to Plan the Audit*
Accounts Receivable (Revenue)	• Large balance relative to total assets • Large number of customer accounts and transactions • Several significant inherent risks associated with revenue recognition policies, completeness and cutoffs, and realization • Complex and detailed computer systems for processing transactions and maintaining records	• Entity control environment factors • Significant classes of transactions • Revenue recognition policies • Significant activities in the initiation, processing and reporting of transactions (e.g., order entry, shipping, billing, cash receipts) • Selected control procedures (e.g., completeness controls, reconciliations of control account to detail, evaluation of past-due accounts)
Inventory (Purchases and Shipping)	• Large balance relative to total assets • Complexity of inventory and number of items in inventory, depending on the nature of the business • Significant inherent risks associated with complex pricing, receiving and shipping, cutoffs, and product obsolescence • Accounting system based on periodic physical inventory counts	• Entity control environment factors • Significant classes of transactions (particularly in manufacturing entities) • Inventory pricing policies • Significant activities in the initiation, processing and reporting of transactions (e.g., accumulation of costs, inventory movement, inventory relief) • Selected control procedures (e.g., completeness controls, cutoff procedures, physical counts, including compilation and pricing)
Long-Term Debt	• Large balance relative to total assets • Small number of debt instruments and few transactions during the year • Inherent risks associated with appropriateness of accounting principles (off balance sheet financing) and compliance with debt covenants • Simple accounting records (general ledger accounts supported by legal documents, journal entries, and other source documents)	• Entity control environment factors • Significant classes of transactions • Significant activities in the initiation, processing and reporting of transactions (e.g., approval of debt, review of journal entries and disclosure) • Significant accounting records (legal documents, general ledger accounts)
Prepaid Expenses	• Small balance relative to total assets • Small number of account balances and transactions • No significant risks • Simple accounting records (general ledger accounts supported by schedules, journal entries, and other source documents)	• Entity control environment factors • Nature of the account balance

system may significantly increase the risk of misstatement. The auditor should consider this risk when designing substantive tests. In addition, the auditor's knowledge of the accounting system provides information about basic characteristics of transactions that is useful in planning audit procedures (for example, information about the existence and nature of records and documents supporting the transactions).

2.44 The auditor should obtain sufficient knowledge of the accounting system to understand --

- o The classes of transactions in the entity's operations that are significant to the financial statements (paragraph 2.45).
- o How those transactions are initiated (paragraphs 2.46-2.47).
- o The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions (paragraph 2.48).
- o The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data (paragraphs 2.49-2.51).
- o The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures (paragraph 2.52).

Significant Account Balances and Classes of Transactions

2.45 The auditor should obtain an understanding of the classes of transactions in the entity's operations that are significant to the financial statements. For less significant classes of transactions or account balances (note prepaid expenses in figure 2-4), having an understanding of the nature of the balance or class and of the control environment may be sufficient for the auditor to plan a primarily substantive audit. Each of the sample companies (Ownco, Inc., exhibits B-2 and B-3; Young Fashions, Inc., exhibits C-2 and C-3; and Vinco, Inc., exhibit D-3) presents illustrations for one significant class of transactions (sales and cash receipts transactions) that involves considerable accounting processing. These examples focus on how the auditor's understanding may change as an accounting system gains complexity. The auditor may not need as extensive an understanding of the elements of the internal control structure for a transaction class, such as long-term debt, because debt generally does not involve complex accounting processing.

How Transactions are Initiated

2.46 For a significant transaction class (such as sales), the auditor should understand how transactions are initiated. This may be a simple matter. For example, in some entities, a sales employee may complete a sales order upon accepting one by telephone. In other entities, such as financial institutions, certain transactions might be initiated by customers (for example, at an automatic teller machine) and recorded by computer.

Other transactions, such as interest earned, periodically may be recorded automatically by the computer system.

2.47 *In Ownco, Inc. (exhibit B-2) and Young Fashions, Inc. (exhibit C-2), there is little difference in the ways in which sales transactions are initiated. Sales orders are written by sales employees and the transactions are approved by the owner-manager and the credit manager, respectively.*[3] *In Ownco, transactions are entered into a microcomputer. The owner-manager, the bookkeeper, and the owner-manager's secretary have sole access. In Young Fashions, sales transactions are entered into remote terminals at divisional offices. The sales manager for Young Fashions reviews and approves changes to the master price file, including those reflected in the "was-is" report.*

Accounting Records, Supporting Documents, Machine-Readable Information, and Specific Accounts

2.48 A sufficient understanding of the accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions varies substantially from one accounting system to another. In general, the auditor will want to identify:

- Source documents
- The conversion of documents to machine-readable files
- The nature of machine-readable files that are further processed in the flow of information to the general ledger and the financial statements
- Documents created and further processed in the flow of information to the general ledger and the financial statements
- Accounts (computer files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

An entity's accounting systems may create many documents, files, and reports that are useful for managing the organization, but the auditor need only understand those aspects that are relevant to the audit of the financial statements. For example, the same system that produces sales invoices and a sales journal may also produce a report of sales by salesperson. An understanding of this report may not be necessary to plan the audit. Neither is it necessary to understand how every copy of accounting documents may be used by the client. When an entity prepares numerous copies of a document, the auditor is concerned only with those relevant to the flow of

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3 Although the auditor often may obtain an understanding of how transactions are approved, an understanding of these control procedures may not be needed to plan a primarily substantive approach.

transactions from initiation to inclusion in the financial statements. However, if the report of sales by salesperson will be used to substantively test commission expense, the auditor needs to understand this report.

Accounting Processing

2.49 While obtaining an understanding of the documents, files, and reports involved in the flow of information to the general ledger and the financial statements, the auditor should obtain an understanding of the accounting processing involved from initiating the transaction to its inclusion in the financial statements, including how the computer is used to process data. This understanding involves knowledge of the ways in which transactions are valued, classified, recorded, and summarized in the journals and ledgers. For some transactions, there may be several significant processing activities and accounting records, including the use of computer programs (for example, accounts receivable and inventory in figure 2-5). Other transactions may involve only limited processing activities performed manually (for example, long-term debt in figure 2-5). Understanding the accounting processing also involves understanding the information used for processing and when processing occurs. For example, when considering the completeness assertion, the auditor normally should understand whether transactions entered into a computer system are processed immediately or in batches, and how frequently batches are processed.

2.50 *The records and methods of Ownco, Inc. that are involved in identifying and recording all valid credit sales include approved sales orders, shipping reports, and the bookkeeper's manual procedures to investigate unmatched sales orders and shipping reports (exhibit B-2). The approved sales order and shipping report contain sufficient information to permit proper classification of the transaction, measure its monetary value, and determine the time period of the transaction. This information is input daily; and the computer prepares sales invoices and posts transactions to the ledgers and journals.*

2.51 *Young Fashions, Inc. uses the computer for a greater amount of processing than does Ownco, Inc. (exhibit C-2). Source documents, such as sales orders and bills of lading, are manually prepared; however, master price information is maintained on a computer file, and the computer is used to generate packing slips, sales invoices, and reports of unmatched documents (sales orders, packing slips, and sales invoices). The auditor's understanding for the Young Fashions audit, therefore, included knowledge of the ways in which transactions and master files are accessed, when and how they are updated, and what processing is done by the computer.*

The Financial Reporting Process

2.52 While gaining an understanding of the financial reporting process, the auditor may ascertain the extent of client procedures to prepare accounting estimates (when significant accounting estimates are called for) and information for significant disclosures. The auditor also should understand the way in which general ledger information is summarized to be able to arrive at the amounts and disclosures reported in the financial statements.

UNDERSTANDING OF CONTROL PROCEDURES

2.53 Most accounting systems involve some computer processing -- whether microcomputer, minicomputer, or mainframe. Each of the three sample companies illustrated in the exhibits uses some form of computer processing. Although the objectives of computer and manual systems are the same, control procedures take on unique characteristics in a computer environment. Paragraph 2.72 discusses various types of control procedures in a computer environment and their interrelationships.

2.54 Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components. After considering such matters as the knowledge obtained from previous audits, the understanding of the industry in which the entity operates, assessments of inherent risk, judgments about materiality, and the complexity and sophistication of the entity's operations and systems, the auditor should determine whether the understanding of the internal control structure is sufficient to enable him or her to identify types of potential misstatements, consider factors that affect the risk of material misstatements, and design substantive tests.

2.55 Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he or she is also likely to obtain knowledge about some control procedures. Except as described in paragraph 2.58, the auditor generally is not required to devote additional attention to understanding control procedures. *In Ownco, Inc., the auditor obtained an understanding of the following control procedures while understanding the control environment and the accounting system:*

- *Owner-manager approval of customer credit*
- *Computer matching of sales orders and shipping reports before the sales invoices are prepared*
- *Manual follow-up procedures for unmatched sales orders and shipping reports*
- *Owner-manager review of billings, sales, and various computer-generated sales summaries*
- *Procedures to reconcile accounts receivable subsidiary ledgers with the general ledger*
- *Owner-manager review of the accounts receivable aged trial balance and follow-up on past-due accounts*
- *Owner-manager follow-up on statements disputed by customers*

In addition, the auditor identified specific risks of misstatement because of inadequate control procedures in the following areas:

- *No control procedures exist to assure that all transactions are posted to the journals and the general ledger.*

- *No specific review of adjustments made to accounting records exists.*

2.56 *In Young Fashions, Inc. (exhibit C-2), the auditor obtained an understanding of the following control procedures while understanding the control environment and the accounting system:*

- *Credit manager approval of sales orders*
- *DP manager periodic review of an access-violation report that reports computer-access violations, such as DP personnel using utility programs to modify data files or accounts receivable clerks accessing accounts receivable master files*
- *Credit manager review and approval of changes to the master price file*
- *Manual follow-up*[4] *of items over five-days-old on the computer-exception reports of unmatched sales orders, bills of lading, and packing slips*
- *Computer check of numerical sequences of sales orders, bills of lading, packing slips, and sales invoices*
- *Matching of sales order, bill of lading, packing slip, and invoice before transactions are posted*
- *Manual procedures to reconcile subsidiary ledgers with the general ledger*

In many circumstances, this understanding may be sufficient to plan the audit.

2.57 *The auditors for both Ownco and Young Fashions, Inc. determined that it was not necessary to devote additional attention to understanding control procedures to plan the audit. The understanding of control procedures obtained while understanding the control environment and accounting system (exhibits B-2 and C-2) was considered adequate to identify types of potential misstatements, understand the factors that affect the risk of material misstatement, and design substantive tests. In Young Fashions, Inc., since significant time pressures did not exist, the auditor planned to visit sufficient operating locations to plan an audit approach based on a planned assessed level of control risk of slightly below the maximum. An alternative audit strategy for Young Fashions, Inc. that requires a greater understanding of control procedures (particularly computer control procedures) is discussed later in paragraphs 2.88 to 2.90.*

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4 As discussed later in paragraph 2.76, the effectiveness of a control procedure that includes a manual review of a computer-produced exception report often is related to the effectiveness of the programmed control procedures over the production of the report.

Circumstances When the Auditor May Be Unable to Use a Primarily Substantive Approach

2.58 In the following circumstances, the auditor may not be able to perform an effective audit using a primarily substantive approach. The auditor may need to devote additional attention to understanding control procedures to --

- o Audit an assertion (particularly the completeness assertion).
- o Plan an audit that is not unreasonably costly.

2.59 Devoting additional attention to control procedures to audit an assertion. The auditor may need to understand specific control procedures to audit an assertion. For example, when auditing a not-for-profit organization with significant cash donations, the auditor may be unable to plan the audit for the completeness assertion for contributions without understanding (and testing) the control procedures related to cash receipts. Similarly, if a financial institution or securities dealer has employees who engage in futures transactions, the auditor may need to understand (and test) the entity's control procedures that provide assurance that all futures commitments are properly accounted for.

2.60 Devoting additional attention to control procedures to plan an audit that is not unreasonably costly. For some assertions, the auditor may conclude that it would be unreasonably costly and impractical to plan effective audit procedures based on a substantive approach. For example, an entity may use a complex and sophisticated computer system to initiate and process certain transactions, and the auditor may determine that the only reasonable audit strategy for some assertions is to obtain an understanding and perform tests of controls sufficient to support a lower assessed level of control risk. In this situation, the auditor should devote additional attention to understanding control procedures, such as computer application control procedures[5] and computer general control procedures, to plan the audit.

2.61 For example, when auditing past-due loans of a financial institution that uses computer-produced reports of such loans, the auditor may be unable to design appropriate substantive tests without knowledge of the specific control procedures concerning the completeness and classification of loans. Because obtaining source documents to audit the completeness and classification of loans in a financial institution may be unreasonably costly, the auditor may decide to plan a lower assessed level of control risk and obtain an understanding of the specific computer application control procedures designed to ascertain that all loans are included and are properly classified in the listing. Computer application control procedures, such as record counts or control totals, may help ensure that all loan files are included in the listing. Programmed reasonableness

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5 Computer application control procedures relate to individual computerized accounting applications, for example, programmed input validation controls for verifying customers' account numbers and credit limits.

tests and cross-footing tests may be designed to detect classification misstatements.

2.62 To assess control risk at a lower level based on the operating effectiveness of programmed-application control procedures, an understanding of the computer general control procedures will usually be obtained. Such computer general control procedures are policies or procedures that affect many applications and often pertain to the following:

- o The development of new programs and systems
- o Changes to existing programs and systems
- o Computer operations
- o Access to programs and data

2.63 The understanding of computer control procedures to support a lower planned assessed level of control risk is discussed later in paragraphs 2.72 to 2.87. This understanding would be considered necessary to plan the audit, if the auditor determines alternative audit strategies would be unreasonably costly.

UNDERSTANDING SUFFICIENT TO PLAN A LOWER ASSESSED LEVEL OF CONTROL RISK

2.64 Figure 2-5 presents the flowchart introduced in chapter 1 and highlights the material to be covered in this section. The auditor may choose a preliminary audit strategy for some assertions based on a lower planned assessed level of control risk. Supporting a lower planned assessed level of control risk may involve obtaining an understanding of additional internal control structure policies or procedures beyond those considered necessary to plan a primarily substantive approach. This section explains and provides examples of the understanding sufficient to plan a lower assessed level of control risk.

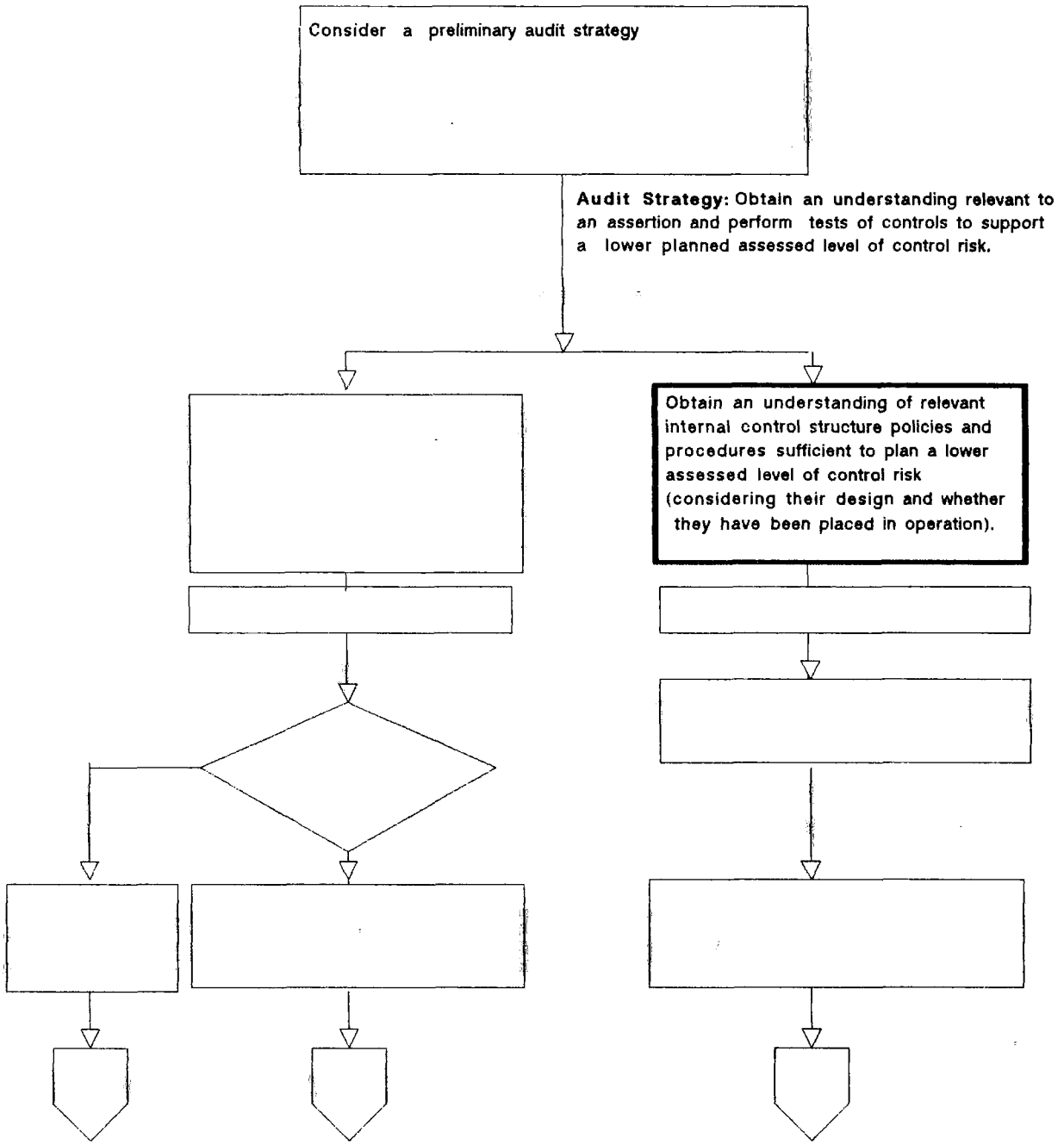
2.65 This section also explains some elements of the internal control structure that the auditor might understand when the computer is used to process accounting transactions. Figure 2-6 summarizes these computer aspects of the control environment, accounting system, and control procedures. As discussed in the preceding section, an understanding of many elements of the control environment and the accounting system presented in figure 2-6 is usually considered necessary to plan a primarily substantive approach. The auditor's understanding of computer control procedures, however, often is affected by decisions about audit strategy and the planned assessed level of control risk. For example, the auditor should obtain an understanding of computer control procedures if computer-produced records are used as evidence, and the auditor does not plan to substantively test such records.

UNDERSTANDING OF THE CONTROL ENVIRONMENT

2.66 The discussions and examples provided previously in paragraphs 2.13-2.63 relate to the audit strategy of planning a primarily substantive

FIGURE 2-5

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



approach. In many circumstances, that level of understanding of the control environment will be sufficient to plan a lower assessed level of control risk. For example, a positive control environment helps ensure that control procedures are more likely to be well-designed and placed in operation. *The auditor of Young Fashions, Inc., may be able to modify the timing of substantive tests based on tests of controls to support a lower assessed level of control risk, with the same understanding of the control environment documented in exhibit C-1.* However, for some assertions, a further understanding of certain control environment factors may be necessary, if a lower assessed level of control risk is planned. Paragraphs 2.67-2.69 discuss this additional understanding.

2.67 The auditor may choose to understand management control methods in greater depth. For example, management may have planning and reporting systems related to business planning, forecasting, profit planning, and responsibility accounting. *The management of Vinco, Inc. has developed a detailed budgeting system, and its general-ledger system produces monthly comparisons of budget with actual performance for each operating location and department (exhibit D-2). Senior management has set guidelines for each department regarding the significance of budget variations that need to be explained. Explanations due within one week of the time variances are identified and carefully reviewed by the controller when he or she develops a monthly performance report. The understanding of how this budget is developed and how variations are explained was considered useful by the auditor of Vinco, Inc. in supporting a lower assessed level of control risk for some assertions.*

2.68 The auditor also may choose to understand in greater detail the activities of the internal audit function. For planning purposes, the auditor ordinarily understands whether internal auditors perform functions relevant to the financial statement audit. The extent to which the auditor obtains an understanding of specific procedures performed by internal auditors is dependent on the auditor's consideration of specific assertions and the audit efficiencies that may be obtained by assessing control risk for those assertions at a lower level. For example, internal auditors in a financial institution may perform tests of controls that provide evidence about the effectiveness of internal control structure policies or procedures related to the valuation of loans receivable, or they may perform detailed tests and analyses of the entity's operations and expenses. Obtaining an understanding of such detailed procedures performed by internal auditors may be relevant to an audit strategy of planning a lower assessed level of control risk.

2.69 *Exhibits D-2 and D-5 present a summary of both the additional understanding of the work of Vinco internal auditors and related tests of controls. The Vinco auditors obtained an additional understanding of the following:*

- *Internal auditors' workpapers related to rotating tests of inventory counts*
- *Compliance with company policies for investment of excess funds*
- *Fixed asset additions*

EXAMPLES OF COMPUTER ASPECTS OF THE INTERNAL CONTROL STRUCTURE

The auditor's primary consideration is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category shown below.

Control Environment

- Involvement of management in setting policies for developing, modifying, and using computer programs and data
- Form and nature of the organizational structure of data processing
- Methods of assigning authority and responsibility over computer systems documentation, including the procedures for authorizing transactions and approving system changes
- Management control methods including methods of establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files
- Personnel policies and procedures
- Involvement of internal auditors

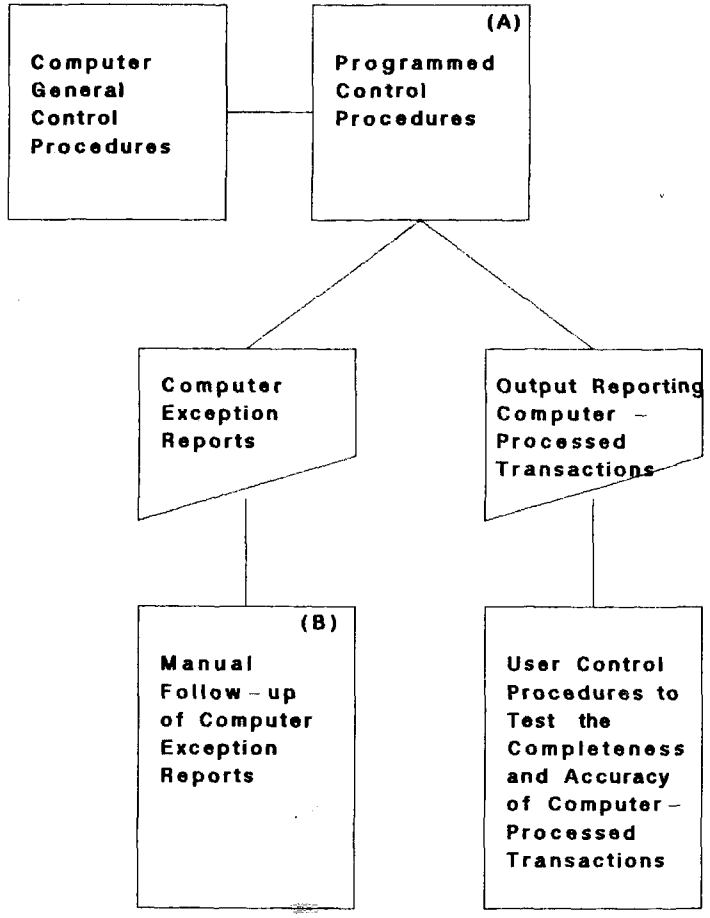
Accounting Systems

- How transactions are initiated
- The accounting records, supporting documents, and specific financial statement accounts involved in the processing and reporting of transactions
- Microcomputer versus complex system; Purchased versus developed software
- How data is converted from source documents to machine-readable information
- Computer files accessed and updated
- Computer processing involved from the initiation of a transaction to its inclusion in the financial statements
- Computer involvement in the reporting process used to prepare the entity's financial statements

Control Procedures

- User control procedures to test the completeness and accuracy of computer processed transactions.
- Computer application control procedures
  - Programmed control procedures (A)
  - Manual follow-up on computer exception reports (B)
- Computer general control procedures
  - Development of new programs and systems
  - Changes to existing programs and systems
  - Computer operations
  - Access to programs and data

COMPUTER CONTROL PROCEDURES



EXPLANATION OF COMPUTER CONTROL PROCEDURES

Computer General Control Procedures control program development, program changes, computer operations, and access to programs and data. These control procedures increase the assurance that programmed control procedures operate effectively during the period.

Application Control Procedures

Programmed Control Procedures relate to specific computer applications and are embedded in the computer program used in the accounting system. The concepts presented here related to programmed control procedures may also apply to procedures within the computer accounting system.

Manual Follow – up of Computer Exception Reports involves employee follow – up of items listed on computer exception reports. The effectiveness of application control procedures that involve manual follow – up of computer reports depends on the effectiveness of both the programmed control procedures that produce the exception report and the manual follow – up procedures.

User Control Procedures to Test the Completeness and Accuracy of Computer Processed Transactions represent manual checks of computer output against source document or other input., and thus provide assurance that programmed aspects of the accounting system and control procedures have operated effectively.

- o *Compliance with purchasing policies and procedures.*

UNDERSTANDING OF THE ACCOUNTING SYSTEM

2.70 The understanding of the accounting system sufficient to plan a primarily substantive approach was discussed in paragraphs 2.43-2.52. This understanding for significant account balances and transaction classes normally includes an understanding of the accounting processing from initiation through the financial-reporting process. This includes an understanding of accounting records, supporting documents, and machine-readable information, including the computer aspects presented in figure 2-6. This understanding of the accounting system may be sufficiently comprehensive that an additional understanding of the accounting system may not be necessary to plan a lower assessed level of control risk. *For example, with the same understanding of the accounting system documented in exhibit C-2, the auditor of Young Fashions, Inc. may be able to modify the timing of substantive tests based on a lower assessed level of control risk. The understanding of the accounting system for Vinco, Inc. is presented in exhibit D-3.*

2.71 However, the auditor may determine that information contained in management reports that was not previously necessary to plan the audit may be relevant to a lower planned assessed level of control risk for some assertions. For example, the accounting system may produce a sales report by inventory stock number for each sales region. Understanding the way in which information for this report is captured, processed, and reported by the accounting system would not be necessary to plan the audit, if the auditor did not plan to use this report. If, however, the auditor decides to use information from this report when auditing the proper valuation of inventory at the lower of cost or market, he or she should obtain an understanding of the following aspects of the accounting system:

- o Which transactions are included in the report
- o How data are entered into the accounting system
- o The files that are processed
- o The nature of processing involved in producing the report

UNDERSTANDING OF CONTROL PROCEDURES

2.72 Supporting a lower planned assessed level of control risk frequently involves obtaining an understanding of control procedures beyond that considered necessary to plan a primarily substantive approach. Control procedures often are more directly related to an assertion than, for example, control environment policies or procedures. As a result, they may be more effective in preventing or detecting misstatements. Designing substantive tests based only on the understanding of the internal control structure sufficient to plan a primarily substantive approach may not be as efficient because --

- o This approach would require more extensive audit procedures at each location.

- o It may be necessary to perform audit procedures at (or closer to) the balance-sheet date, which might not be efficient.

- o It may be difficult to obtain the necessary accounting records from remote locations (rather than machine-readable information in a central location).

- o Reports and other evidence used in the audit could be generated by the computer system, which affects their completeness and accuracy. It may not be efficient to perform substantive tests directed at verifying this information.

2.73 In planning the audit, the auditor may identify assertions for which a lower assessed level of control risk is desired. For example, this often is appropriate for certain assertions relevant to accounts in the revenue class of transactions because of the complexity of accounting processing, the materiality of these accounts, and the large number of transactions processed. For these account balances, however, obtaining an understanding of additional control procedures may not be necessary for every assertion. *Vinco, Inc. has complex accounting systems and control procedures relevant to the assertions of completeness, existence, and occurrence for the revenue cycle (exhibit D-3). Examples of this complexity are extensive automation from initiation of the transaction through recording in the general ledger, programmed control procedures, on-line computer terminals at many locations, and client use of computer-produced information for decision making. For audit-efficiency reasons, the auditor chose to understand internal control structure policies and procedures sufficient to plan a lower assessed level of control risk.*

2.74 As outlined in figure 2-6, control procedures in a computerized environment generally comprise a combination of user control procedures, computer application control procedures (programmed control procedures and manual follow-up procedures), and computer general control procedures. When planning a lower assessed level of control risk, the auditor should consider the extent of the understanding of each of these types of control procedures that, when considered in conjunction with the understanding of the control environment and accounting system, is needed. The following are some common alternatives for understanding control procedures that, together with tests of such controls, may be sufficient to plan a lower assessed level of control risk:

- o User control procedures

- o Computer application control procedures (programmed control procedures and manual follow-up procedures)

- o Computer general control procedures and manual follow-up procedures

User Control Procedures

2.75 If the auditor plans a lower assessed level of control risk, he or she might consider an audit strategy involving an understanding of user control procedures and their tests. User control procedures represent manual checks of the completeness and accuracy of computer output against source documents or other input. For example, an entity may have programmed procedures in a

billing system that calculate sales-invoice amounts from shipping data and master-price files. The entity may also have user control procedures to check manually the completeness and accuracy of the invoices. In many systems, user control procedures relate only to the completeness of records and not to the accuracy of processing. User control procedures may provide evidence that the programmed control procedures operate effectively, in which case the auditor may choose to understand and test the user control procedures. If these control procedures are designed and operating effectively, these tests may support a lower control risk assessment.

Programmed Control Procedures and Manual Follow-up Procedures

2.76 If the auditor plans a lower assessed level of control risk, he or she might consider an audit strategy of understanding and testing programmed control procedures and related manual follow-up procedures. For example, the auditor may use computer-assisted audit techniques, such as test data or parallel simulation, to test the programmed control procedure that produces an exception report. These tests provide evidence about the design and operation of programmed control procedures. However, they do not provide evidence about the consistent application of the control procedure throughout the audit period; they provide evidence only about the point in time when they are performed. It may be costly to perform such tests throughout the period to achieve a lower control risk assessment. Frequently, auditors find that it is more efficient to follow the approach set forth in paragraph 2.77. The auditor also needs to understand and test the manual follow-up procedures (that is, follow-up on the items listed on the exception report) because the effectiveness of the control procedures relates to both an accurate computer-produced exception report and an effective manual follow-up of the exceptions.

Computer General Control Procedures and Manual Follow-up Procedures

2.77 If computer general control procedures operate effectively, there is greater assurance that programmed control procedures are properly designed and function consistently throughout the period. Tests of computer general control procedures, combined with tests of manual follow-up procedures, often provide the evidential matter sufficient to plan a lower planned level of control risk. The auditor may plan to understand computer general control procedures and perform tests of controls to obtain evidence that --

- Programs are properly designed and tested in development.
- Changes to programs are properly made.
- Adequate access controls reduce the risk of unauthorized changes to the program and data files.

The auditor should understand programmed control procedures and obtain sufficient evidence about the effective design and operation of various computer general control procedures to draw a conclusion about the effective design and operation of the programmed control procedures. In addition, the auditor should understand and test the manual follow-up procedures to obtain evidence that the entity adequately resolves exceptions raised by the programmed control procedures. The degree to which the auditor may need to

test programmed control procedures depends on the effectiveness of controls over the development of and changes to such procedures.

2.78 *An example of this approach is the audit of Vinco, Inc. where the planned assessed level of control risk is based, in part, on understanding programmed control procedures, manual follow-up procedures, and general control procedures. The following are examples of programmed control procedures performed by the billing program (exhibit D-3):*

- *Computer-generated batch totals of the number of cases shipped are compared with manually computed totals entered during data entry.*
- *The numerical sequence of bills of lading is checked and any breaks in the sequence reported.*
- *Bill-of-lading input fields (such as customer number and quantity shipped) are checked to ensure they contain data.*
- *Check digits ascertain whether customer and product numbers are valid.*
- *Numeric and range controls determine whether customer-number, product-number, and quantity-shipped fields contain only numeric characters and are within prescribed ranges.*
- *Quantities actually shipped are compared to quantities scheduled for shipment.*

Differences detected by any of these procedures are investigated and corrected.

2.79 Computer general control procedures include controls over the development of new programs and systems, changes to existing programs and systems, computer operations, and access to programs and data.

2.80 The development of new programs and systems. These computer general control procedures are intended to ensure that new application systems are suitably authorized, designed, and tested. These include such elements as user involvement in the design and approval of systems, check points where users review the completion of various phases of the application, development of test data and testing of the program, user involvement in the review of tests of the programs, and adequate procedures to transfer programs from development to production libraries. *In Vinco, Inc., procedures performed to obtain the understanding of computer general control procedures revealed that no new application systems related to significant financial statement assertions were developed.*

2.81 Changes to existing programs and systems. These computer general control procedures are intended to ensure that modifications to application programs are suitably approved, designed, tested and implemented. The issues associated with controls over program and system changes are the same as those related to the development of new applications and include such items as user involvement in the design and tests of changes, adequate testing of modified programs, and adequate procedures to transfer programs from development to production libraries. *In Vinco, Inc., these control*

procedures include the written approvals of changes by both the appropriate user department manager and the data processing manager, reports on program maintenance management, tests of program changes, and review of final revised program documentation.

2.82 Computer operations. These computer general control procedures are intended to ensure that application programs are used properly and that the proper data files are used during processing. They involve schedules of regular batch jobs (including estimated run times), exception reports showing deviations from schedules, unscheduled jobs reviewed by operations management, job-control instructions, jobs executed only from the operator's terminal, and programs checking internal machine-readable labels on files before processing begins. *The auditor's documentation of the understanding of control procedures over computer operations is not illustrated for Vinco, Inc.*

2.83 Access to programs and data. These computer general control procedures are intended to prevent or detect unauthorized changes to programs and to data files supporting the financial statements and include program and data access, as well as physical access. Access to programs and data is generally controlled with software that limits: programmer access to production programs, live data files, and job control language; operator access to source code and individual elements of data files; and user access to defined programs and data files.

2.84 *Vinco, Inc.'s access control procedures include --*

- *Restricting access to the computer with a combination lock, segregating programmers from the computer room with no access to production programs or data files.*
- *Having no dial-in lines to the computer.*

Software control procedures include --

- *Integrated computer librarian and security packages licensed by a reputable vendor.*
- *Company policies over the use of passwords.*
- *General utility librarian package (GULP) that maintains control over production and development programs. Only changes initiated through GULP can be placed in production. In addition, GULP limits the ability to make production library changes to certain computer management personnel. GULP also prints transfer logs of all transfers to and from development and production libraries and prepares logs of when programs were compiled (that is, translating the program from source code to object code).*
- *General access security package (GASP) that limits write access to production libraries, logs violations of programmed access, and maintains profiles of users and privileges and changes to users and such privileges.*

Manual Follow-up Procedures When Planning a Primarily Substantive Approach

2.85 Paragraphs 2.72-2.84 discussed the understanding of control procedures in computer systems and planned tests of controls sufficient to support a lower assessed level of control risk. The following example provides a discussion of circumstances in which the auditor plans an audit strategy that is primarily substantive in nature.

2.86 In this illustration, an entity's programmed control procedure might consist of a computer process that matches sales orders and shipping documents. On a regular basis, the program produces an exception report of unmatched documents. When sales orders and shipping documents are matched, a sales invoice is generated. A user department employee follows up on the listed exceptions and makes inquiries about why, for example, goods have not been shipped for an outstanding sales order. In some cases, the manual follow-up procedures are such that the employee only follows up on items listed on the report and does not obtain any information about the completeness and accuracy of the computer-produced report. In such circumstances, procedures performed related to the manual follow-up would not provide evidence about the effective operation of the programmed control procedure to enable the auditor to assess control risk below the maximum.

2.87 In other circumstances, however, the manual follow-up procedure might be placed in operation in such a way that the employee does, in fact, obtain information about the operation of the programmed control procedure. For example, the employee's job function might include direct communication with the shipping department, sales personnel, and customers. Information obtained about the last sales orders issued, the last item shipped, open sales orders, and shipping status may provide information on not only the exceptions noted on the report, but also on the completeness and accuracy of the report. The employee might inquire of warehouse personnel about unfilled orders older than a specified period, inquire of sales management about customer inquiries on delayed shipments, and determine whether those items are included on the exception report. In this circumstance, the auditor may perform the following tests of controls while obtaining the understanding:

- Inquire of the employee about the manual follow-up procedures (for example, if items appear on the report on a timely basis, how long it takes for items to clear from the report, and how often items do not clear from the report that should have cleared, based on the employee's knowledge)

- Corroborate inquiries of sales and shipping personnel regarding the accuracy of items listed as exceptions on the report

- Examine some reports to determine that selected items appear on the report and clear from the report on a timely basis

If these tests of controls indicate that unmatched records appear on the report and clear from the report in a timely and orderly manner, the auditor has evidence that the programmed control is operating effectively. These tests, however, do not directly test the application control, and evidence of consistent application of the control throughout the audit period depends on the extent to which the auditor examines and tests exception reports.

Although these procedures might allow the auditor to assess control risk at a moderate level, they often may support only an assessed level of control risk of slightly below the maximum.

AN EXAMPLE -- UNDERSTANDING ADDITIONAL INTERNAL CONTROL STRUCTURE POLICIES AND PROCEDURES FOR YOUNG FASHIONS, INC.

2.88 Young Fashions, Inc. was described earlier in this chapter. To illustrate how changes in audit strategy may affect the auditor's understanding of internal control structure policies and procedures, this discussion assumes that, in a subsequent year, the client requests a tighter deadline for rendering the audit report. In this example, the auditor decides on an audit strategy where a further reduction in the assessed level of control risk is important to the decision to move certain substantive work to an interim date.[6]

2.89 *The auditor's understanding of the control environment of Young Fashions, Inc. (exhibit C-1) would probably not change because of the decision to modify the timing of substantive tests based on a lower assessed level of control risk. The understanding of the accounting system documented in exhibits C-2 and C-3 should be adequate to plan the revised audit strategy. The auditor's understanding of the control environment reveals that senior management does not appear to be sensitive to the functional and technical limits of data processing. Management has delegated authority and responsibility to the data processing manager and is not actively involved in setting or monitoring policies. The CFO reviews computer output primarily for the purpose of controlling operations.*

2.90 *The major change in audit strategy relates to the understanding of control procedures. In this example, the auditor determined that it would be efficient to understand and test computer control procedures that, because of the control environment concerns, would likely support a moderate assessed level of control risk for certain assertions. This included obtaining an understanding of application control procedures. In addition to the understanding of some computer application control procedures documented in exhibit C-2 (such as the computer-generated list of unmatched sales orders, bills of lading, packing slips, and sales invoices weekly and at month end), the auditor obtained an understanding of programmed control procedures that affect the processing of routine transactions such as control procedures over input of valid data (for example, check digits or range controls) or processing of transactions (such as batch-control totals). In addition, the auditor obtained an understanding of the computer general control procedures to determine whether there was adequate assurance that the programmed control procedures operated effectively during the year.*

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6 SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol.1, AU sec. 313), indicates that assessing control risk below the maximum is not required for extending audit conclusions from an interim date to the balance sheet date. However, if the auditor does not intend to assess control risk below the maximum for the purpose of modifying the timing of substantive tests, he or she should consider whether the effectiveness of certain of the substantive tests to cover that period will be impaired.

The auditor also performed sufficient tests of controls to support the lower control risk assessment. This increased level of understanding might be similar to that documented for Vinco, Inc. in exhibits D-3 and D-4.

NATURE AND EXTENT OF AUDIT PROCEDURES PERFORMED TO OBTAIN THE UNDERSTANDING

2.91 In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. The auditor obtains that understanding of the internal control structure through --

- o Previous experience with the entity.
- o Inquiries of appropriate management, supervisory, and staff personnel.
- o Inspection of entity documents and records.
- o Observation of entity activities and operations.

In making a judgment about the nature and extent of these procedures, the auditor considers the types of factors outlined in figure 2-7.

2.92 Knowledge of the types of misstatements occurring in prior audits (for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from the lack of sufficient personnel to handle a heavy seasonal workload) influences the nature of the inquiries about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, as well as the nature and extent of any such changes. In a continuing audit, the auditor may also have significant experience with and documentation of the internal control structure that will allow the auditor to focus attention on system changes. For example, the auditor might use prior experience with commercially available software, combined with knowledge of how the software was installed in the entity's accounting system, to obtain an understanding of features of the internal control structure. While previous experience may affect the nature and extent of procedures performed to obtain the understanding, the level of understanding should be sufficient to support the planned assessed level of control risk.

2.93 *Some internal control structure policies and procedures provide documentary evidence in the form of policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to plan the audit. For example, budgetary control procedures normally provide documentation. Inspecting some documentation of the investigation of variances from budgets, together with making inquiries about the nature of the investigation, may be sufficient to determine whether this procedure is suitably designed and placed in operation.*

FIGURE 2-7

EXAMPLES OF FACTORS THAT AFFECT THE NATURE AND EXTENT OF PROCEDURES FOR AN UNDERSTANDING SUFFICIENT TO PLAN THE AUDIT

Example Factors	*Effect on the Nature of Procedures*	*Effect on the Extent of Procedures*
Previous Experience With the Entity		
Knowledge of prior misstatements	Procedures focus on changes, if any, in the internal control structure to correct problems	
Prior permanent file documentation of the understanding	Inquiries about changes in the internal control structure	Reduce extent of procedure to understand the design of the internal control structure
Nature of the Entity's Documentation of Specific ICS Policies or Procedures		
Extensive client accounting manuals, flowcharts, or other internal control structure documentation	Focus on whether relevant internal control structure policies or procedures are placed in operation	Less extensive inquiry and observation to understand design and placed in operation
Nature of the Particular Policy or Procedure		
Internal auditors perform duties relevant to the internal control structure	Procedures should be appropriate to understand the relevant work performed by internal auditor	More extensive procedures may be necessary to understand work performed by functions within internal audit
Size and Complexity of the Entity		
Complex organization structure	Focus attention on methods of assigning authority and responsibility	More extensive procedures performed through the organization, such as inquiry of more personnel
Complex computer systems	May need to understand computer general control procedures	
Multiple locations		May perform more extensive procedures to assure systems at multiple locations have not changed

2.94 *In a simple system, such as the revenue class of transactions depicted for Ownco, Inc., the auditor examined completed documents for selected transactions and limited inquiries to employees who worked directly with the transactions. The auditor examined selected sales orders to determine whether they had been approved by the owner-manager and, as part of understanding controls over the completeness assertion, observed the open files and procedures to follow up on unmatched sales orders, shipping reports, and sales invoices.*

2.95 *In a more complex system, such as the revenue class of transactions depicted for Young Fashions, Inc., observation and examination are often more extensive. In this example, information about quantities ordered and quantities shipped are input at remote locations, and significant computer processing is involved. The auditor did not observe this process at every location; however, the auditor made inquiries about whether the same system was placed in operation at each location. Among other matters, the auditor made inquiries about how data were input, the type of data captured by the computer system, and how the master-price file was updated. During this process, the auditor made inquiries about and observed access to programs and data files and reviewed the computer output (that is, reports that were produced).*

2.96 Documentation may not be available for other internal control structure policies and procedures. For example, the understanding of management's philosophy and operating style may be obtained through prior experience updated by inquiries of management and observation of their actions. *In Young Fashions, Inc., prior experience was updated by inquiries of the chief executive, chief operating, and chief financial officers, focusing on new developments in the current year. The auditor also made inquiries of middle-management personnel in a position to observe the degree to which management focused on growth in sales or earnings. In contrast, inquiries were less extensive in an owner-managed entity such as Ownco, Inc., because management and control are centralized with one individual. However, the auditor made inquiries of others in the organization to corroborate the owner-manager's representations. In both examples, the auditor also was able to make observations related to management's philosophy and operating style.*

2.97 In obtaining an understanding of the design of computer-programmed control procedures and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control procedures design and may inspect exception reports generated as a result of such control procedures to determine that they have been placed in operation.

2.98 The auditor's assessment of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

DOCUMENTING THE UNDERSTANDING

2.99 Figure 2-8 presents the flowchart introduced in chapter 1 and highlights the matters covered in this section. The auditor's documentation of the internal control structure should provide evidence that an understanding sufficient to plan the audit was acquired. For a business with a simple internal control structure, a memorandum may be adequate. Flowcharts, questionnaires, and the like may be used for documenting more complex internal control structures. However, an auditor is not required to document procedures performed to obtain the understanding.[7]

2.100 The auditor may concurrently obtain and document the understanding. For example, if the auditor uses a questionnaire to acquire the understanding of the control environment, completion of the questionnaire may be sufficient documentation. Similarly, the auditor may concurrently obtain an understanding of and document the accounting system and control procedures while preparing a flowchart. After preparing or obtaining the documentation in one year, the auditor may be able to limit documentation in subsequent years to updating the prior documentation to reflect changes in the internal control structure.

2.101 Exhibits B-1, C-1, and D-2 provide illustrations of three of many possible formats for documenting the understanding of the control environment. While these illustrations of memorandum and questionnaire formats present the auditor's understanding of control environment factors in one location of the working papers, this is not required.

2.102 Although the auditor should consider the major factors of the control environment, the documentation does not need to address every possible factor. The auditor need only document the aspects of the control environment that he or she believes are relevant to the financial statement audit. For example, exhibit B-1 does not address elements such as audit committees or internal auditors since they are not relevant to this owner-managed business.

2.103 Exhibits B-2 through B-4, C-2 and C-3, and D-3 and D-4 provide examples of documentation of various aspects of the accounting system and control procedures for Ownco, Young Fashions, and Vinco. These examples include narratives, flowcharts, questionnaires, and combinations of each. However, the auditor does not need to use each form of documentation. For example, for some smaller entities, it may be practical to document the understanding with a memorandum only. In general, each of these forms of documentation identifies the transactions involved and addresses the following:

- How the transactions are initiated
- The source documents
- The accounting processing

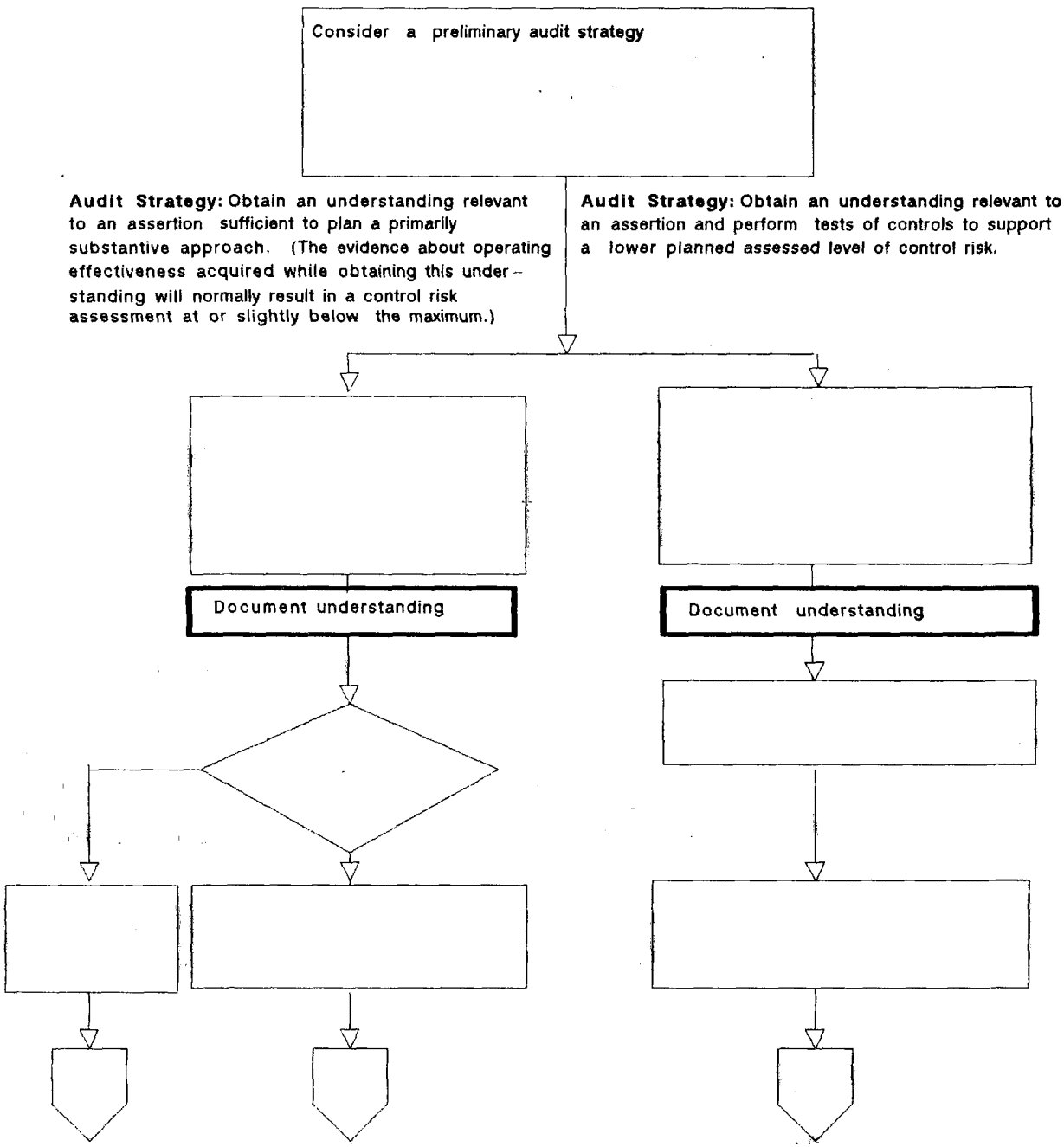
---

7 These procedures should be documented, however, if they also serve as tests of controls.

- The computer files, if any, involved and how they are updated
- The documents, journals, ledgers, and reports generated by the accounting system
- Control procedures

FIGURE 2-8

FLOWCHART OF THE AUDITOR'S CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



CHAPTER 3

ASSESSING CONTROL RISK

CONTROL RISK ASSESSMENT CONCEPTS

3.1 Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. Assessing control risk is the process of evaluating the design and operating effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in financial statement assertions. The conclusion reached as a result of assessing control risk is referred to as the assessed level of control risk.

3.2 Control risk should be assessed for relevant assertions related to significant account balances or transaction classes. The auditor also may choose to assess control risk for specific objectives that relate to assertions. For example, it may be appropriate to divide the valuation assertion into two separate objectives -- gross valuation and net realizable value -- because of the different risk factors, internal control structure policies and procedures, and planned substantive tests associated with these objectives. Separate control risk assessments are made for these two objectives for Ownco, Young Fashions, and Vinco (see exhibits B-5, C-4, and D-6, respectively).

3.3 In other cases, an assessment may be made for a combination of assertions relating to an account balance (for example, the auditor may jointly assess control risk for the existence, rights and obligations, and/or valuation assertions for an account balance). The risk of misstatement for some assertions may not be significant to an account balance (for example, rights and obligations for investments in unconsolidated subsidiaries). Hence, the auditor does not need to assess every assertion for every account balance or transaction class. *For example, in Ownco, Inc., a combined control risk assessment is made for existence, rights and obligations, and gross valuation related to accounts receivable because all of these assertions (or objectives) are affected by the same internal control structure policies and procedures (exhibit B-5).*

ASSESSING CONTROL RISK AT THE MAXIMUM

3.4 Control risk should be assessed at the maximum (the greatest risk that a material misstatement that could occur will not be prevented or detected on a timely basis by the internal control structure) for some or all assertions if --

- Policies and procedures are unlikely to pertain to an assertion.
- Policies and procedures are unlikely to be effective.
- It would not be efficient for the auditor to obtain evidential matter to evaluate their effectiveness.

The auditor should recognize that, although the level of assurance needed from substantive tests remains the same whether the control risk is assessed at the maximum because of efficiency reasons or because of ineffective policies and procedures, the fact that the auditor concludes that policies or procedures are ineffective may raise concerns about auditability and other questions. Assuming that the auditor is able to overcome auditability concerns, he or she may respond by heightening the degree of professional skepticism, assigning more experienced staff, and changing the nature, timing, and extent of substantive procedures.

ASSESSING CONTROL RISK AT LESS THAN THE MAXIMUM

3.5 Assessing control risk below the maximum[1] involves --

- o Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- o Performing tests of controls to evaluate the effectiveness of such policies and procedures.

3.6 Tests of controls are directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the auditor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

3.7 Tests of controls directed toward the effectiveness of operation of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include evidence obtained from --

- o Inquiries of appropriate entity personnel.
- o Inspection of documents and reports indicating performance of the policy or procedure.
- o Observation of the application of the policy or procedure.

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1 Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, for a maximum to a minimum. For illustrative purposes in the exhibits to this proposed audit guide, control risk is assessed using the terms maximum, slightly below maximum, moderate, and low.

- o Reperformance of the application of the policy or procedure by the auditor.

In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

THE DEGREE OF ASSURANCE PROVIDED BY TESTS OF CONTROLS

3.8 When the auditor assesses control risk below the maximum, he or she should obtain evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides the auditor as he or she develops an assessed level of control risk. The auditor's decisions about the nature, timing, and extent of tests of controls, and the interrelationship of evidential matter, affect the degree of assurance evidential matter provides. These matters are discussed in the following paragraphs.

The Nature of Tests of Controls

3.9 The nature of the particular policies and procedures that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those policies or procedures. For control structure policies or procedures for which documentary evidence exists, the auditor may choose to examine the documents. For other controls (such as segregation of duties or some control procedures performed by a computer), documentation may not exist. For these controls, the auditor may choose to observe the control in operation or use computer-assisted audit techniques to reperform the control. Control procedures that are pervasive to the entity or to the entire period often can be tested only by inquiry and observation (for example, segregation of duties). As a result, such inquiries and observations provide sufficient evidential matter to support a conclusion about the operating effectiveness of the control policy or procedure.

3.10 Some tests of controls are more effective than others and provide more assurance about effectiveness of the design and operation of internal control structure policies or procedures. Evidence from tests of controls obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. The auditor should consider, however, that the observed application of a policy or procedure might not be performed in the same manner when the auditor is not present. Also, inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the operating effectiveness of a specific control policy or procedure.

3.11 An auditor, for example, may decide to obtain evidence of the effectiveness of the design and operation of an entity's budgetary control methods. The auditor could make inquiries of management about what variations from budget are investigated and the procedures for reporting the reasons for these variances. Based solely on this inquiry, generally the auditor will assess control risk at the maximum. The effectiveness of tests of controls may be increased by obtaining more competent evidence (such as

examining documents) and by asking more detailed questions about reporting systems (such as how personnel follow up on budgets, the timeliness of the investigations, and the nature of the reports). By combining these inquiries with examination of written explanations of variances, the auditor can determine the operating effectiveness of these policies and procedures. This documentation may provide direct evidence for assessing the effectiveness of the control environment policy or procedure in preventing or detecting and correcting misstatements in the financial statements.

The Extent of Tests of Controls

3.12 More extensive tests of controls usually provide increased evidential matter about the consistency of application of a control structure policy or procedure and, as a result, provide more assurance about the auditor's conclusions regarding the assessed level of control risk than less extensive tests. For controls performed on a daily or other periodic basis, observation alone may not be sufficient since it applies only to one point in time. Additional observations will increase the assurance provided by such evidence. The auditor performs more extensive tests by performing tests at more than one date, selecting more documentary evidence, or in the case of inquiry, asking more than one person about the same control procedures.

3.13 *For example, the tests of controls performed relevant to Ownco's accounts receivable (exhibit B-6) represent procedures performed while obtaining an understanding sufficient to support a primarily substantive audit approach. Observations were performed only during a one-week period when the auditor was in the field. Inquiries of the owner-manager and bookkeeper and examination of the documents supporting the owner-manager's sales authorization and follow-up on accounts receivable were not extensive. As a result the auditor assessed control risk for the valuation of receivables at their gross amount as slightly below the maximum.*

3.14 *In contrast, the auditor might have planned a lower assessed level of control risk. To support this alternative plan, the auditor might make more extensive inquiries and observe owner-manager procedures while maintaining contact with the client during the year for other purposes. The auditor might also examine specific aged trial balances or ask the owner-manager to explain his review to ascertain how effective this procedure is in ensuring the proper valuation of receivables at their gross amount. Depending on the extensiveness of such procedures, and the degree to which they support a conclusion of effective design and operation of relevant policies and procedures, the auditor might be able to support a control risk assessment of moderate or low.*

Timing of Tests of Controls

3.15 The timing of tests of controls is concerned with when evidential matter was obtained and the portion of the audit period to which it applies.

3.16 Interim Procedures. Auditors often perform tests of controls during interim work. When the auditor obtains evidential matter about the design or operation of internal control structure policies and procedures during an interim period, he or she should determine what additional evidence should

be obtained for the remaining period. In making that determination, the auditor should consider --

- o The significance of the assertion involved.
- o The specific internal control structure policies and procedures that were evaluated during the interim period.
- o The degree to which effective design and operation of those policies and procedures were evaluated.
- o The results of the tests of controls used to make that evaluation.
- o The length of the remaining period.
- o The evidential matter about design or operation that may result from the substantive tests performed in the remaining period.

3.17 The auditor should obtain evidential matter about the nature and extent of any significant changes in the internal control structure, including its policies, procedures, and personnel, that occur subsequent to the interim period. For example, after considering the matters discussed in the previous paragraph, the auditor might make inquiries about changes in internal control structure policies and procedures, observe employees in the performance of their duties during the performance of other audit procedures, or examine evidence supporting the continued effectiveness of such policies and procedures. If the audit procedures indicate that significant changes had occurred in relevant internal control structure policies, procedures, or personnel, the auditor should consider performing more extensive tests. In general, the longer the remaining period, the more extensive the procedures the auditor should perform to conclude that the control risk assessment to the interim period is applicable to the remaining period. Alternatively, the auditor may consider performing substantive analytical procedures or tests of details covering the remaining period.

3.18 Some internal control structure policies and procedures, such as some aspects of the control environment or segregation of duties, leave no documented audit trail. Inquiries directed at such policies and procedures should relate to the entire period under audit, but observations of such policies and procedures may be confined to the periods during which the auditor is present on the client's premises in conducting other phases of the audit.

3.19 Prior Audits. Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit. To evaluate the use of such evidential matter for the current audit, the auditor should consider --

- o The significance of the assertion involved.
- o The specific internal control structure policies and procedures that were evaluated during the prior audits.

- o The degree to which the effective design and operation of those policies and procedures were evaluated.

- o The results of the tests of controls used to make those evaluations.

- o The evidential matter about design or operation that may result from substantive tests performed in the current audit.

The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

3.20 When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. In considering evidence about such changes, the auditor might consider evidence about the effective design and operation of internal control structure policies and procedures that are intended to ensure that changes in other policies or procedures are suitably designed and implemented. These policies and procedures might include the following:

- o Methods of assigning authority and responsibility for approving system changes

- o Management's direct control over the exercise of authority delegated to others for developing and modifying accounting systems control procedures, including the development, modification, and use of any related computer programs and data files, and management's ability to supervise such policies

- o Internal audit tests of system changes

- o Computer general control procedures

The auditor might consider the results of inquiries about changes in other internal control structure policies and procedures and the degree to which tests of controls corroborate management's representations about changes in the system. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period. The auditor exercises professional judgment in determining whether the timing of tests of controls, together with the nature and extent of such tests and the interrelationship with other evidential matter, support a conclusion about the continuing effectiveness of the design and operation of relevant internal control structure policies or procedures.

The Existence of Other Evidential Matter

3.21 Generally, when various types of evidential matter support the same conclusion about the effectiveness of the design or operation of an internal control structure policy or procedure, the degree of assurance provided

about the auditor's conclusions regarding the assessed level of control risk increases. Conversely, if various types of evidential matter lead to different conclusions about the effectiveness of the design or operation of an internal control structure policy or procedure, the assurance provided decreases.

3.22 For example, an auditor may test computer general control procedures over access to programs and data. In the process, the auditor may perform the following tests:

- o Observe physical access
- o Determine the existence of control procedures over dial-in lines
- o Make inquiries of the data processing manager, programming manager, and other data processing employees
- o Examine logs and reports generated by general librarian and security software
- o Attempt unauthorized access to programs and data

If the results of these tests of controls are favorable, the auditor has increased assurance about operating effectiveness. If, on the other hand, inquiries of employees or inspection of documents provide conflicting evidence about the design and operation of internal control structure policies and procedures, the assurance from these tests decreases, and the auditor should consider resolving the conflicting information or increase the planned assessed level of control risk.

3.23 The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to evaluate the effective design or operation of an internal control structure policy or procedure. For example, an auditor may observe that programmers are not authorized to operate the computer. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances when programmers attempted to operate the computer to determine how such attempts were prevented or detected.

3.24 When evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, accounting system, and control procedures. Although an individual internal control structure element may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual element in relation to the evidential matter about the other elements in assessing control risk for a specific assertion. For example, the auditor may obtain evidence that an owner-manager has established effective policies for developing and modifying accounting systems and control procedures. The auditor also may determine that an effective perpetual inventory system has been designed and placed in operation. The auditor may be able to reduce

the number of observations of control procedures to obtain the same assurance about operating effectiveness that would be needed in other circumstances with a less effective control environment. Similarly, based on evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control procedures, the auditor obtains evidential matter that such procedures are ineffective, the auditor may reevaluate prior conclusions about the control environment and, among other things, decide to perform auditing procedures at additional locations.

3.25 An audit is a cumulative process. As the auditor assesses control risk, the information obtained may cause him or her to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. Chapter 4, paragraph 4.2, provides additional guidance about the relationship of the evidence obtained from tests of controls to the auditor's reconsideration of the planned audit strategy.

ASSESSING CONTROL RISK BASED ON PROCEDURES TO OBTAIN THE UNDERSTANDING SUFFICIENT TO PLAN A PRIMARILY SUBSTANTIVE APPROACH

3.26 Figure 3-1 presents the flowchart introduced in chapter 1 and highlights the matters to be covered in this section. Paragraphs 3.28-3.34 address situations in which the auditor's preliminary audit strategy is to assess control risk based only on the procedures performed to obtain the understanding sufficient to plan a primarily substantive approach that may also serve as tests of controls. For some assertions, this may result in a control risk assessment at the maximum or, for other assertions, below the maximum. These paragraphs provide guidance for making these assessments.

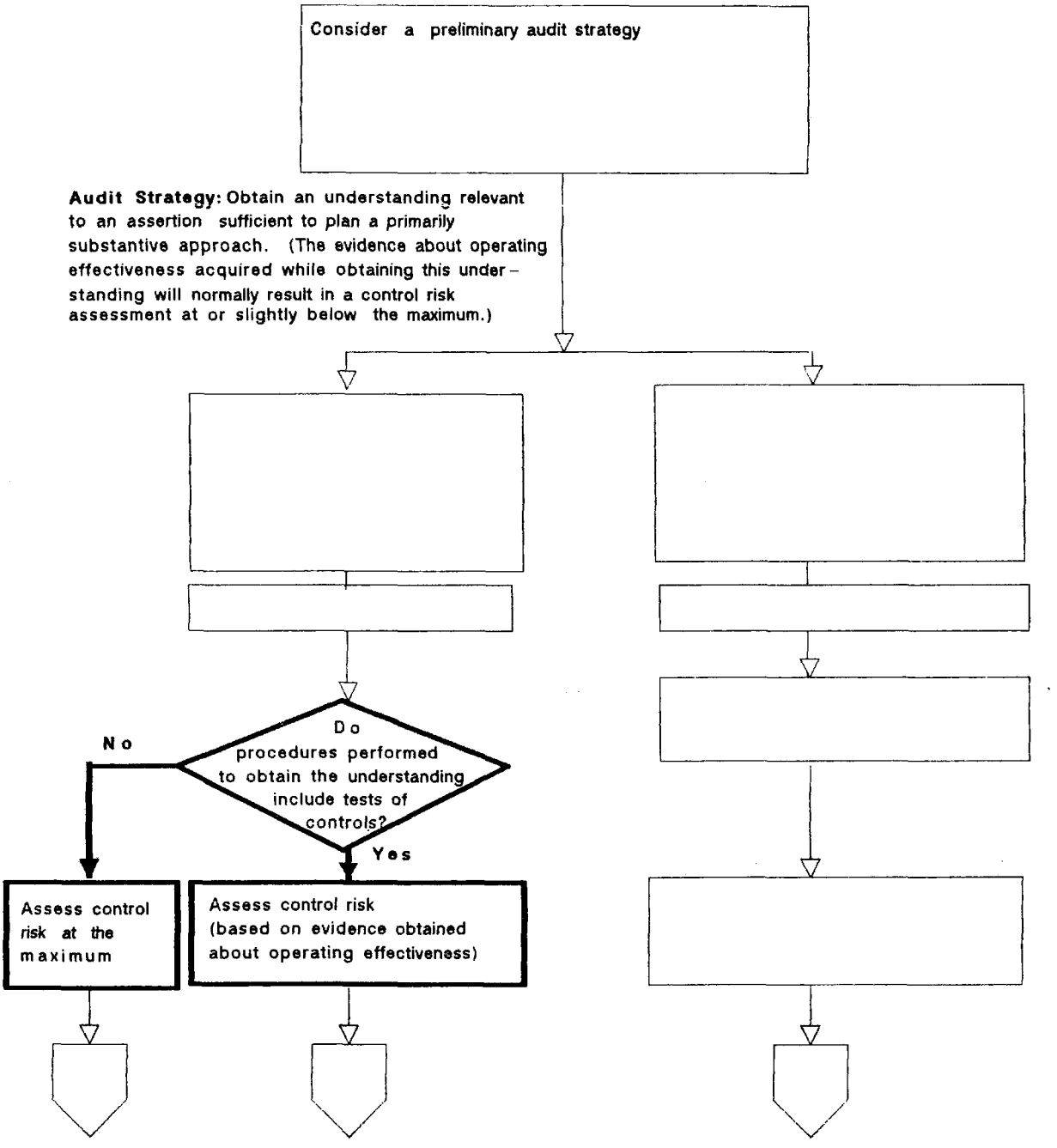
3.27 The procedures discussed in paragraph 3.8 may also provide evidence about the effective design and operation of the internal control structure. The following discussion contains examples, in the context of Ownco and Young Fashions, of how these procedures also may serve as tests of controls. (See the control risk assessments in exhibits B-5, B-6, and C-4, respectively.)

ASSESSING CONTROL RISK AT THE MAXIMUM

3.28 For some assertions, an auditor may decide to assess control risk at the maximum because control structure policies or procedures do not pertain to an assertion or are unlikely to be effective, or because evaluating their effectiveness would be inefficient. *The auditor for Ownco, Inc. determined that the company had not designed effective policies or procedures related to the collectibility of receivables. In Young Fashions, Inc., concerns about the control environment (particularly management's philosophy and operating style) led the auditor to believe that any policies or procedures related to the estimation of an allowance for doubtful accounts would likely be ineffective. As a result, control risk for the net realizable value of receivables was assessed at maximum in both audits.* For other assertions, the auditor may assess control risk at the maximum, because it may be more effective or efficient to do so. *For example, in Ownco, Inc., the auditor decided that it would be more efficient to assess control risk at the maximum for all assertions related to account balances such as cash, fixed*

FIGURE 3-1

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



assets, or notes payable, and to design appropriate substantive tests (exhibit B-5).

ASSESSING CONTROL RISK BELOW THE MAXIMUM

3.29 Even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions, and consequently, serve as tests of controls to support a control risk assessment below the maximum.

3.30 Caution, however, is necessary. Procedures performed in obtaining the understanding cannot support an assessment of control risk below the maximum unless they provide evidence to evaluate the effectiveness of design and operation of internal control structure policies and procedures. Accordingly, the auditor should consider that --

- Evidence from prior audits may be affected by subsequent changes in the internal control structure.
- Evidence from inquiry depends on the extent of the inquiries, and inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of a specific control policy or procedure.
- Observation of employees in the performance of their duties may corroborate evidence obtained from other sources, but pertains only to the point in time at which the observation was made.
- Evidence from inspection of documents depends on the extensiveness of inspections made.

In determining whether evidential matter obtained is sufficient to support an assessed level of control risk below the maximum level, the auditor should consider the assurance provided by that evidential matter. The following paragraphs provide several examples of how the auditor might assess control risk based on procedures performed to obtain an understanding of the internal control structure that is sufficient to plan the audit.

3.31 *In Ownco, Inc., the auditor determined that the owner-manager demonstrated a conservative attitude toward business risks through prior experience with the entity, inquiry of the owner-manager, and inspection of documentation of business decisions made during the year (exhibit B-6). Through inquiry, observation, and walking selected*[2] *transactions through the system, the auditor also determined that significant changes had not been made in the accounting system, and that access to the computer system was*

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2 The extent of tests of controls that supports a control risk assessment of slightly below the maximum, moderate, or low is a matter of professional judgment. This proposed audit guide often refers to selected tests, without specifying an explicit extent of tests, to allow for such judgment.

limited to the owner-manager and two other office employees. Based on these procedures, the auditor assessed control risk at slightly below the maximum for the existence and rights and obligations assertions.

3.32 *For the completeness assertion, the auditor also made inquiries about the procedures performed by the bookkeeper to follow up on documents in the unmatched documents file. Documents in this file were inspected, and no unrecorded transactions were discovered. The auditor also made inquiries of the owner-manager about the timeliness with which sales are recorded and the extensiveness of review of weekly sales and shipping reports. Inquiries were also made of the bookkeeper about the extent of owner-manager review of sales. Because no problems were noted while examining documentary evidence, and based on the extensiveness of owner-manager review, the auditor assessed control risk for the completeness assertion as moderate.*

3.33 *For the gross valuation objective of the valuation assertion for accounts receivable, the auditor determined that, as part of the accounting system, the bookkeeper compared invoice amounts with supporting documentation. However, the only independent review of the valuation of transactions consisted of the owner-manager's review of weekly sales and shipping reports. As a result, control risk for this objective was assessed as slightly below the maximum.*

3.34 *In Young Fashions, Inc., the auditor assessed control risk for the objective of gross valuation of receivables and sales as slightly below the maximum (exhibit C-4). The auditor made inquiries of the sales manager and employees in the sales office about the effectiveness of manual follow-up of a "was-is" computer report of changes to the master-price file. Inquiries also addressed the employees' knowledge of the completeness and accuracy of the computer report. Supporting documentation was examined for selected transactions, and no exceptions were noted. Based on past experience, inquiries of entity personnel, and the examination of selected documents, the auditor was concerned about the high turnover of personnel and the accuracy of quantity information used to value sales and receivables, particularly at the Texas location. As a result, the auditor assessed control risk at slightly below maximum for the objective of gross valuation of receivables and sales at all operations except those in Texas, for which the auditor assessed control risk at the maximum, because he or she believed that control structure policies and procedures at that location were likely to be ineffective.*

TESTS OF CONTROLS TO SUPPORT A LOWER PLANNED ASSESSED LEVEL OF CONTROL RISK

3.35 For certain assertions, the auditor may seek to assess control risk at a lower level than that at which it would be assessed from procedures performed to obtain the understanding sufficient to plan a primarily substantive approach that may serve as tests of controls. Therefore, the auditor may develop a preliminary audit strategy involving sufficient tests of controls to support a lower planned assessed level of control risk. The primary differences between the strategy discussed in paragraphs 3.26-3.30 and that are discussed in this section are as follows:

- The auditor may obtain an understanding of internal control structure policies or procedures in greater depth or of additional policies and procedures than those considered to plan the audit.

- The auditor performs tests of controls to support a lower assessed level of control risk.

Understanding the internal control structure in greater depth was explained in chapter 2, paragraphs 2.64-2.87. Assessing control risk at a lower level depends on the assurance provided by tests of controls about the effectiveness of design and operation of the internal control structure. The auditor may perform such tests of controls either simultaneously with or following procedures performed to obtain an understanding of relevant control structure policies or procedures. The auditor may also plan to perform tests of controls concurrently with substantive tests (such as, "dual-purpose tests"), which may provide evidence to support a planned assessed level of control risk below maximum.

3.36 Supporting a lower planned assessed level of control risk is reflected in the right side of the flowchart in figure 3-2. Figure 3-2 highlights the sections covered in the remainder of this chapter, which discusses tests of controls to support a lower assessed level of control risk.

AUDIT EFFICIENCY CONSIDERATIONS REGARDING A LOWER PLANNED ASSESSED LEVEL OF CONTROL RISK

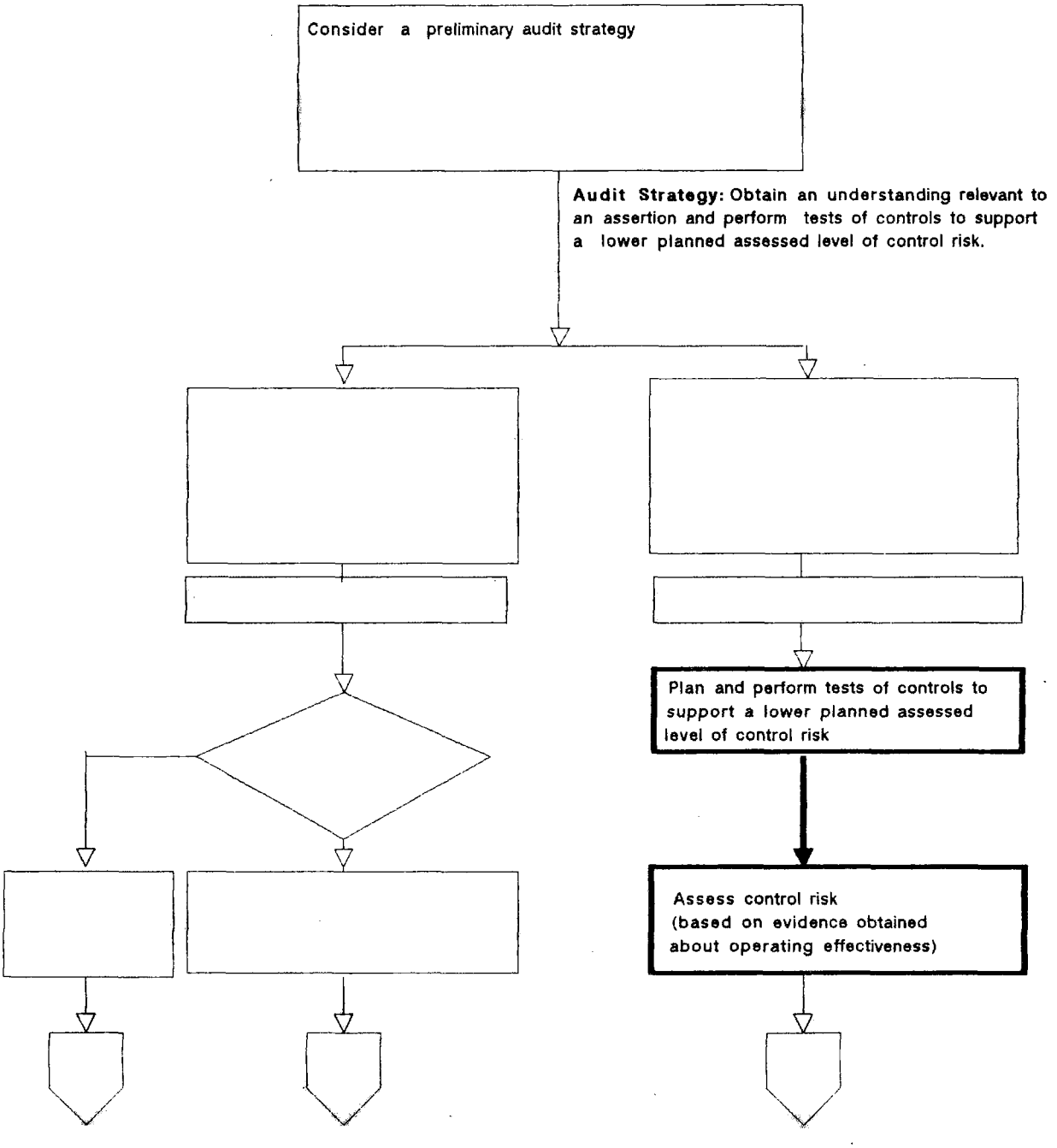
3.37 The auditor may plan a lower assessed level of control risk for audit-efficiency reasons. In considering efficiency, the auditor recognizes that obtaining evidence about the design and operating effectiveness of internal control structure policies and procedures supports a lower planned assessed level of control risk, which would result in less audit effort from substantive tests of that assertion. For example, an auditor may choose to understand and test computer-application and general controls rather than substantively test certain reports used in the audit. The auditor weighs the increase in audit effort associated with the planned tests of controls against the resulting decrease in audit effort associated with a higher level of detection risk.

3.38 *For Ownco, Inc. and Young Fashions, Inc., the auditors decided that they could perform a more efficient audit following a primarily substantive approach. Vinco, Inc. is a larger company with more complex operations and systems. The auditor decided that the audit would be more efficient if he planned a lower assessed level of control risk for certain assertions. The auditor supported this strategy by understanding additional internal control structure policies and procedures (discussed in chapter 2, paragraphs 2.64-2.87) and by planning and performing tests of controls (discussed in this chapter). In addition, because of a client request for a tighter reporting deadline, an alternative audit strategy is presented for Young Fashions, Inc. In this new scenario, the auditor plans and performs tests of controls to support a lower assessed level of control risk.* This discussion provides a contrast with the approach for the Young Fashions' audit presented earlier.

3.39 Obtaining additional evidential matter that supports a lower assessed level of control risk should result in a modification in the nature, timing,

FIGURE 3-2

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



or extent of substantive audit procedures. The auditor may choose to modify the audit procedures in one or more of the following ways:

- Changing the nature of substantive tests from more effective to less effective procedures (for example, using tests directed toward parties or documentation within the entity rather than tests directed toward independent parties outside the entity). Sufficient tests of controls also might allow the auditor to consider the elimination of substantive tests of information on computer reports used in the audit.

- Changing the timing of substantive tests, such as performing them at an interim date rather than at year end.[3]

- Changing the extent of substantive tests, such as using a smaller sample size.

SUPPORTING A LOWER ASSESSED LEVEL OF CONTROL RISK

Identifying Internal Control Structure Policies and Procedures

3.40 A lower assessed level of control risk is related to the effectiveness of internal control structure policies or procedures in preventing or detecting and correcting financial statement misstatements. The auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transaction classes and, therefore, can often affect many assertions. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

3.41 Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

3.42 Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more direct the relationship, the more effective that policy or procedure may be in reducing control risk for that assertion. For example, when auditing the existence of inventories, an entity may have management-control methods such that

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3 See note 6, chapter 2.

management closely monitors gross-profit percentages from month to month, an accounting system that maintains perpetual inventory records, and control procedures that require physical counts of inventories at the end of every quarter. Such regular physical-inventory-count procedures that compare actual assets with the recorded accountability are more likely to detect and correct misstatements than management's monitoring of gross-profit percentages.

ASSESSING CONTROL RISK BASED ON PLANNED TESTS OF CONTROLS

3.43 The following paragraphs provide examples of how the auditor may plan and perform tests of controls to support a lower assessed level of control risk.

Vinco, Inc.

3.44 *The auditor for Vinco, Inc. planned to support a low control risk assessment for the objective of proper valuation of accounts receivable at the gross amount by performing tests of controls to obtain evidence about the effective design and operation of the control environment, accounting system, and certain control procedures. Because of the nature of the policy or procedures tested, many of these tests of controls may also be relevant to other assertions.*

Control Environment

3.45 *The auditor performed tests of controls to obtain evidence about various control environment factors to assess management's attitudes, awareness, and actions concerning the control environment. For example, the auditor considered previous experience with the entity and performed the following procedures to assess management control methods with respect to data processing:*

- *Inquiry of the VP Administration, the DP Manager, internal auditors, and others within data processing regarding the substance of how management established and monitored policies for developing and modifying accounting systems and control procedures*
- *Examination of organizational charts, correspondence between the VP Administration and the DP Manager, and internal auditor workpapers (in this audit strategy, the effectiveness of data processing aspects of the control environment would also be confirmed while testing specific computer control procedures)*
- *Observation of management and employees in the performance of their day-to-day activities*

Examples of the auditor's documentation of these tests of the control environment are found in exhibits D-2 and D-5 (workpapers C-30 and C-40). The auditor's assurance that computer general and application controls are operating effectively can be increased by obtaining evidence that the data

processing aspects of the control environment are properly designed and operating effectively.

Accounting System

3.46 *The auditor's tests of the accounting system comprised procedures performed by the auditor while he or she obtained the understanding of the accounting system. These tests included:*

- *Questioning employees with responsibility for sales, shipping, accounting, and computer processing.*
- *Examining source documents and computer output at various stages in the accounting process.*
- *Observing employees performing accounting functions at various locations.*

In addition, the auditor confirmed the assessment about the effective operation of the accounting system as substantive tests were performed. The auditor's understanding and tests of the accounting system are documented in exhibits D-3, D-4, and D-5 (workpaper R-100), along with tests of specific control procedures.

Control Procedures

3.47 *In planning a low assessed level of control risk, Vinco's auditor planned to assess the operating effectiveness of certain programmed control procedures related to the gross valuation of receivables and sales. For example, Vinco, Inc. has a programmed control procedure to check the quantities used to prepare sales invoices. As noted in exhibit D-3, the billing program compares the Daily Shipments File with the Daily Priced-Out Sales Order File and produces a report that lists differences between quantities actually shipped and quantities scheduled for shipment. Differences are investigated by the accounting clerk, and corrections are entered on the terminal. The effectiveness of the control procedure depends on the effectiveness of both the programmed control and the manual follow-up procedures.*

3.48 *Vinco's auditor determined that the most efficient way to assure that relevant programmed-application control procedures functioned consistently throughout the period was to test the operating effectiveness of computer general control procedures. As discussed in chapter 2, paragraphs 2.77-2.84, the auditor planned to obtain evidence of effective operation of computer general control procedures and manual follow-up procedures to support a low assessed level of control risk. In addition, the auditor planned to use a combination of prior experience with computer applications, and tests of general computer control procedures over the design of, or changes to, programmed application control procedures, to assure that applications were operating effectively. To achieve this low assessed level of control risk, the auditor planned tests of computer general control procedures to obtain evidence that --*

- *Programmed control procedures were properly designed and tested in development.*

- *Changes to programmed control procedures were properly made.*

- *Adequate access controls reduce the risk of unauthorized changes to the programmed control procedures.*

3.49 *The tests of Vinco's general control procedures are illustrated in exhibit D-5 (workpapers G-30 and G-40). During the year, Vinco, Inc. developed no new systems. The auditor's tests of program changes included examination of the following:*

- *Reports used to evaluate adherence to quality-assurance standards*

- *Program-change logs generated by the general utility librarian package (GULP)*

- *Written approvals by appropriate department managers and the data processing manager*

- *Program-maintenance reports and logs of the program development manager*

- *Final revised program documentation*

- *Acceptance of test results*

- *GULP transfer logs showing when programs were transferred from and to the production library*

- *GULP compile logs showing when the programs were compiled into object code*

Such tests were designed to obtain evidence about the effective design and operation of general computer control procedures as they were applied to programmed applications. In the process, the auditor obtained evidence about the approval, design, and testing of related changes in the revenue and payable/disbursements systems.

In addition, inquiries were made of the following:

- *User department managers regarding their involvement in the approval and testing process*

- *The data processing manager regarding program changes and adherence to established programming standards*

Tests of computer general control procedures pertaining to access to programs and files included obtaining an understanding of the vendor-supplied librarian and access security packages (GULP and GASP), observation of physical access to computer facilities, inquiries of the security officer and other computer personnel regarding security, and inspection of GULP

librarian administration reports and user attribute reports, set attribute reports, and reports showing user privileges. In addition, the auditor made attempts to access computer programs with improper passwords and reviewed reports recording the attempts to access the system by unauthorized users. These tests supported an assessment that general controls were operating effectively.

3.50 *In assessing the effectiveness of the specific programmed control procedure, the auditor considered evidence obtained in a prior year about the effectiveness of the design of the programmed control that compared quantities shipped and billed. In addition, the auditor obtained assurance in the current period that there was a low risk that the program was changed without adequate testing before implementation.*

3.51 *To assess control risk for this aspect of the valuation assertion as low, the auditor also tested the effectiveness of manual follow-up procedures. These tests of controls included the following:*

- *Inquiries of the accounting clerk about the frequency and extent of differences between quantities shipped and those scheduled for shipment, and about the procedures for entering the correct quantities at the terminal*
- *Inquiries of shipping personnel about the frequency of such differences*
- *Inquiries of accounts receivable personnel about the frequency of customer complaints about incorrect billings during the period and the causes of such misstatements*
- *Examination of customer correspondence*
- *Observation of the accounting clerk performing follow-up procedures at several times during the audit*
- *Examination of selected computer reports listing differences for follow up, and related sales invoices and shipping documents to determine that quantities billed matched the quantities actually shipped*

No deviations from the prescribed procedures were found. These tests of the computer general control procedures and manual follow-up procedures were considered sufficient to assess control risk as low for this aspect of the valuation assertion.

3.52 *User control procedures to check the completeness and accuracy of changes to the master-price file are not illustrated in this example. However, the Vinco auditor considered the above tests of general control procedures to be sufficient so that the primary attention was focused on the manual follow-up procedures associated with changes to the master-price file.*

3.53 *The entity relies on the order entry and billing programs to produce accurate invoice calculations and does not recheck amounts. The entity*

does, however, follow up on customer correspondence and the reasons for complaints about improper billings. To obtain evidential matter to support a low control risk assessment for the objective of proper valuation of gross receivables, Vinco's auditor performed tests of controls that included the following:

- *Consideration of prior experience that the program produced accurate invoices*
- *Tests of general control procedures to assure that there was a low risk of programs being changed without adequate testing*
- *Inquiries of personnel that follow up on customer correspondence to determine the extent of and reason for billing errors*
- *Examination of customer correspondence*

Young Fashions, Inc.

3.54 *Chapter 2, paragraphs 2.88-2.90, provides an example where the auditor for Young Fashions, Inc. modified the audit strategy to support a change in the timing of substantive tests based on a lower assessed level of control risk. Many programmed control procedures are involved in processing sales transactions, and as a result, the auditor planned an audit strategy similar to that explained above for Vinco in determining whether such transactions are valid and are properly valued. This strategy involved understanding and testing the control environment, accounting system, computer general control procedures, and related manual follow-up procedures.*

3.55 *In performing tests of the control environment, the auditor determined that, because of the close supervision of the DP Manager, management control over data processing was appropriate for the size of the company. The DP Manager performed an assessment of sensitive programs and data files to determine whether access restrictions were appropriate. In addition, data processing output was reviewed by user departments and by the CFO for purposes of controlling operations.*

3.56 *Under this revised strategy, the tests of the accounting system did not change substantially from those performed to obtain the understanding of this element of the internal control structure.*

3.57 *The major changes in audit strategy involved tests of control procedures. These control procedures are most directly related to specific assertions, and as a result, obtaining evidence of effective design and operation of these controls allows for a significant reduction in the control risk assessment. Young Fashions' accounting system is highly computerized, and most control procedures involve programmed controls and manual follow up.*

3.58 *The auditor determined the most efficient way to obtain assurance about the design and consistent operation of programmed application control procedures was by testing the computer general control procedures. In this case, tests of computer general control procedures might be similar to those described above in connection with the Vinco audit.*

3.59 *Tests of the effectiveness of Young Fashions, Inc.'s manual follow-up procedures were essentially the same as those discussed in paragraph 3.51.*

CHAPTER 4

REEVALUATING THE PRELIMINARY AUDIT STRATEGY, DOCUMENTING THE CONTROL RISK ASSESSMENT, AND DESIGNING SUBSTANTIVE AUDIT PROCEDURES

4.1 This chapter provides the following guidance:

- Reevaluating the preliminary audit strategy
  - -- Considering a further reduction in the assessed level of control risk
  - -- Considering whether the assessed level of control risk supports the planned level of substantive tests
- Documenting the control risk assessment
- Designing substantive tests

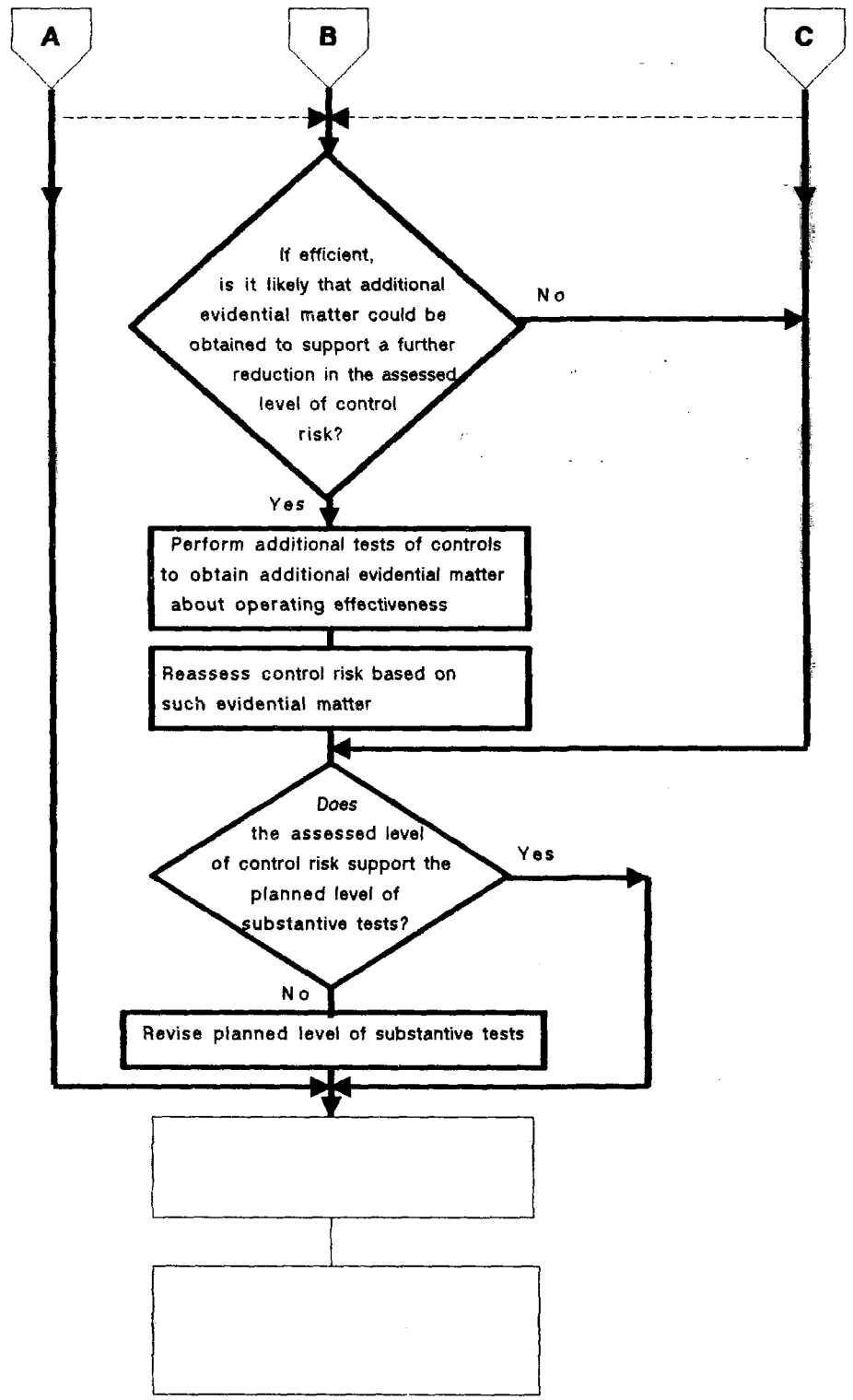
REEVALUATING THE PRELIMINARY AUDIT STRATEGY

4.2 Figure 4-1 presents the flowchart introduced in chapter 1 and highlights the material covered in this section. After understanding the internal control structure and assessing control risk, the auditor may acquire evidence that causes him or her to reassess the preliminary audit strategy for an assertion. For example, the auditor may have planned to perform tests of controls concurrent with obtaining an understanding of the internal control structure. In this process, the auditor may have obtained unanticipated information about changes in the design of the internal control structure or about its operating effectiveness. Depending on the nature of the changes in internal control structure policies, procedures, or personnel, the auditor may consider either --

- A further reduction in the assessed level of control risk.
- Revising planned substantive tests, because the results of tests of controls do not support the planned level of substantive tests.

FIGURE 4-1

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



A FURTHER REDUCTION IN THE ASSESSED LEVEL OF CONTROL RISK

4.3 After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, helps the auditor to evaluate those two factors.

4.4 *For example, the auditor of Young Fashions, Inc. assessed control risk as slightly below the maximum for the existence of accounts receivable based on the procedures to obtain the understanding sufficient to plan a primarily substantive approach that served as tests of controls. In a subsequent year, the auditor changed audit strategy by planning a lower assessed level of control risk (see chapter 3, paragraphs 3.54 - 3.59). The auditor found that additional personnel were hired and trained to correct the prior personnel problems that had been experienced in Texas. In addition, the auditor also discovered that the company upgraded its computer systems and that management established and monitored formal policies for developing and modifying the system changes. Upon obtaining this understanding, the auditor determined that additional evidential matter about operating effectiveness of relevant policies or procedures would likely be available, and that it would be efficient to plan a lower control risk assessment.*

DOES THE ASSESSED LEVEL OF CONTROL RISK SUPPORT THE PLANNED LEVEL OF SUBSTANTIVE TESTS?

4.5 When performing tests of controls, the auditor may find exceptions from prescribed control structure policies or procedures. The auditor should consider both the rate of deviations detected by pertinent procedures and the qualitative aspects of the deviations. If the auditor concludes that the results of tests of controls do not support the planned assessed level of control risk for an assertion, he or she should reevaluate the nature, timing, and extent of the planned substantive procedures based on a revised consideration of the assessed level of control risk for the relevant financial statement assertions.

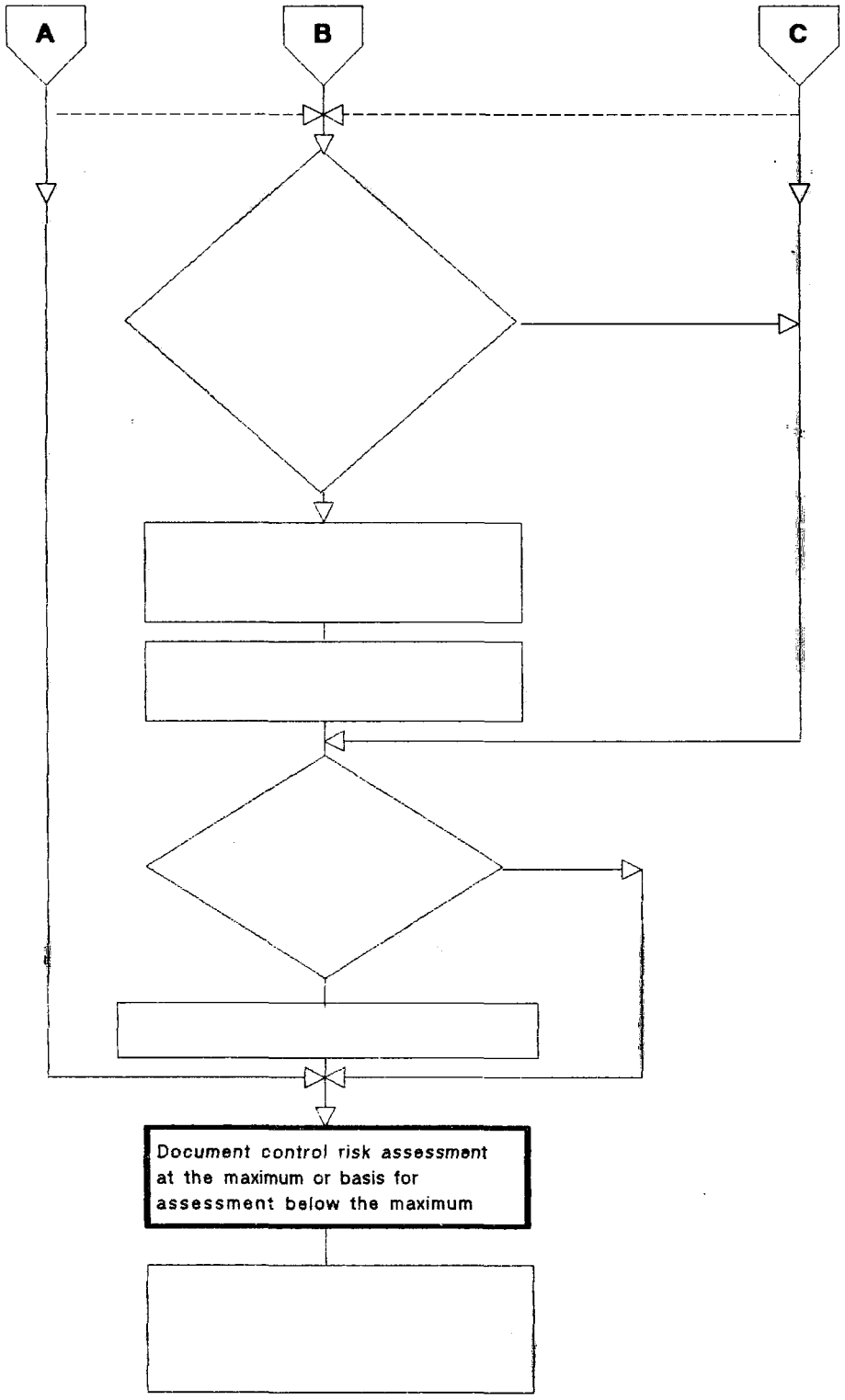
4.6 For example, if results of tests of controls of approval of credit to customer accounts indicate unauthorized transactions, the auditor should revise the control risk assessment for completeness of accounts receivable. Accordingly, this may lead the auditor to expand substantive testing of returns and allowance documentation.

DOCUMENTING THE CONTROL RISK ASSESSMENT

4.7 Figure 4-2 highlights the material from the flowchart introduced in chapter 1 that is discussed in this section. Control risk should be assessed for significant assertions embodied in the financial statements. Internal control structure policies or procedures may relate to one or more assertions.

FIGURE 4-2

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



The assessment may also be aggregated to reflect the auditor's assessment of internal control structure policies or procedures relevant to several assertions, or to reflect a combined assessment of inherent and control risks.

4.8 Figure 4-3 summarizes the auditor's responsibility for documenting his or her conclusions about the assessed level of control risk. For account balances or assertions for which control risk is assessed at the maximum, the auditor need only document that it is at the maximum. The auditor need not document the basis for this assessment.

4.9 For account balances or assertions for which control risk is assessed below the maximum, the auditor should document the basis for the assessment. The documentation of the basis for the assessment should be evidenced by the tests of controls applied to internal control structure policies or procedures and their results. The assessed level of control risk may be expressed quantitatively (for example, as a percent) or qualitatively (for example, slightly below the maximum, moderate, or low). However, SAS No. 55 does not require the auditor to document the specific level below the maximum.

DESIGNING SUBSTANTIVE TESTS

4.10 Figure 4-4 presents the flowchart introduced in chapter 1 and highlights the material covered in this section. After considering the level to which the auditor seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of substantive tests performed.

THE AUDITOR'S CONSIDERATION OF CONTROL RISK AT THE ACCOUNT BALANCE AND TRANSACTION CLASS

4.11 After considering the assessments of inherent risk and control risk, the auditor's decisions about the nature, timing, and extent of substantive tests should be made in light of the appropriate level of detection risk. The auditor makes judgments about the nature of substantive tests based on an assessment of the effectiveness and efficiency of the available alternative procedures in detecting material misstatements. The procedures may include substantive analytical procedures, substantive tests of details, or a combination of both. Judgments about the nature, timing,[1] and extent of audit procedures are influenced by the --

- o Assessment of the inherent risk of material misstatement.
- o Materiality of transactions and balances.

---

1 Decisions about the timing of audit procedures may be affected by other factors discussed in SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313).

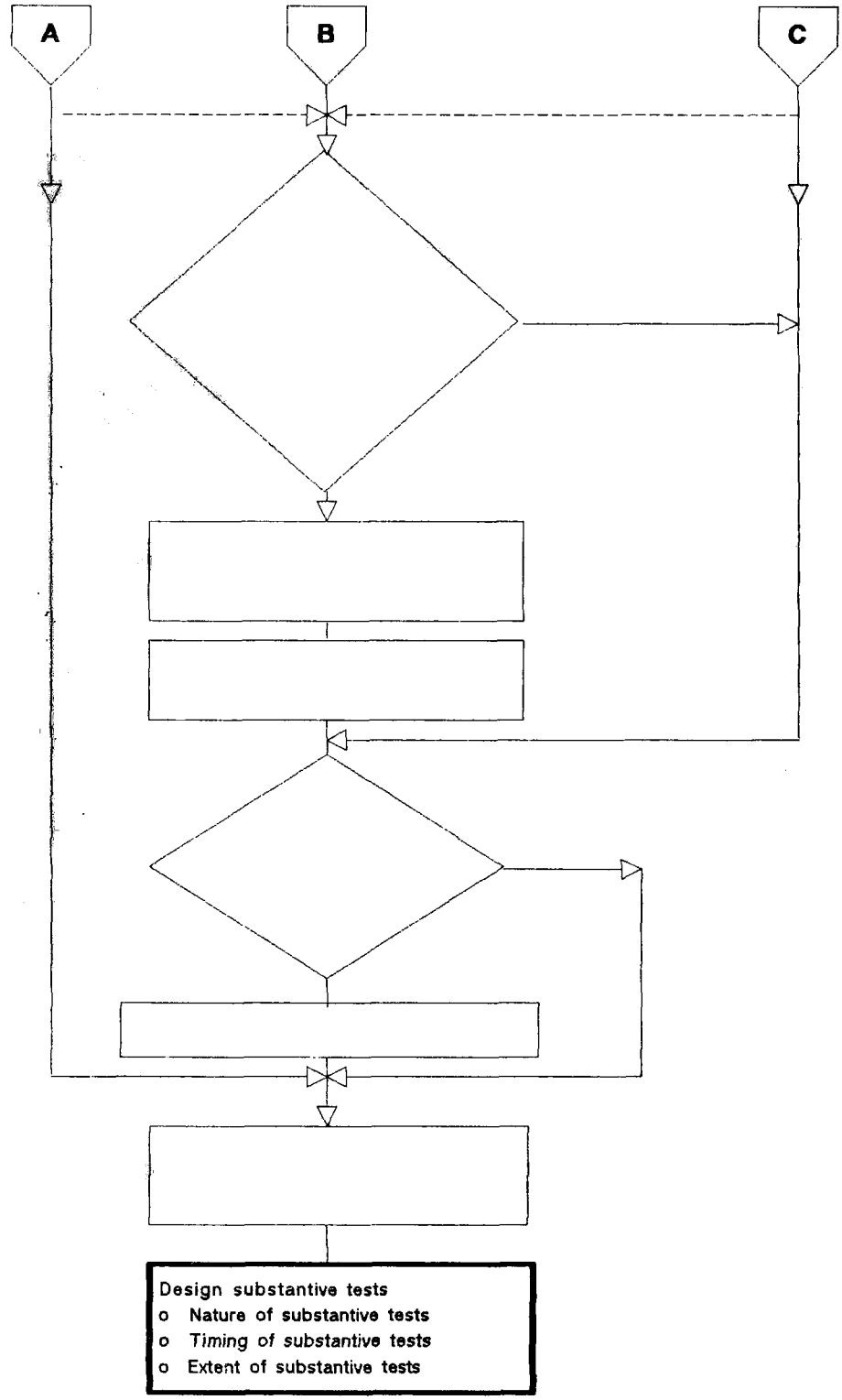
FIGURE 4-3

SAS NO. 55 DOCUMENTATION REQUIREMENTS

	Assess Control Risk at the Maximum	**Assess Control Risk Below the Maximum**
Document the Assessed *Level of Control Risk*	**Yes** The auditor should document the assessment of control risk at the maximum. (see paragraph 4.8)	**No** The auditor need not document the level at which control risk is assessed below the maximum. (see paragraph 4.9)
Document the Basis for the Control Risk Assessment	**No** The auditor need not document the basis for assessing control risk at the maximum. (see paragraph 4.8)	**Yes** The auditor should document the basis for assessing control risk below the maximum. (see paragraph 4.9)

FIGURE 4-4

FLOWCHART OF THE AUDITOR'S
CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE
AND ITS RELATION TO SUBSTANTIVE TESTS FOR SOME OR ALL ASSERTIONS



- o Assessed level of control risk.
- o Amount, volume, and variability of transactions and balances.
- o The effectiveness of other available audit procedures.

4.12 Figure 4-5 presents one example of a table, stated in qualitative terms, that shows how an auditor might relate his or her assessments of inherent and control risk levels to the judgment about the appropriate level of detection risk for various combinations of substantive analytical procedures and tests of details. For example, assume that the auditor assesses inherent risk as maximum and control risk as low (because tests of the design and operating effectiveness of relevant internal control structure policies or procedures support an assessment of low). Using the table in figure 4-5, the auditor may plan to perform substantive analytical procedures that he or she judges to be very effective. Such procedures reduce detection risk to a sufficiently low level, eliminating the need to perform substantive tests of details. Alternatively, if no analytical procedures are performed as substantive tests, the auditor should obtain assurance from tests of details. Other approaches, including tables that utilize quantitative methods, are also appropriate.

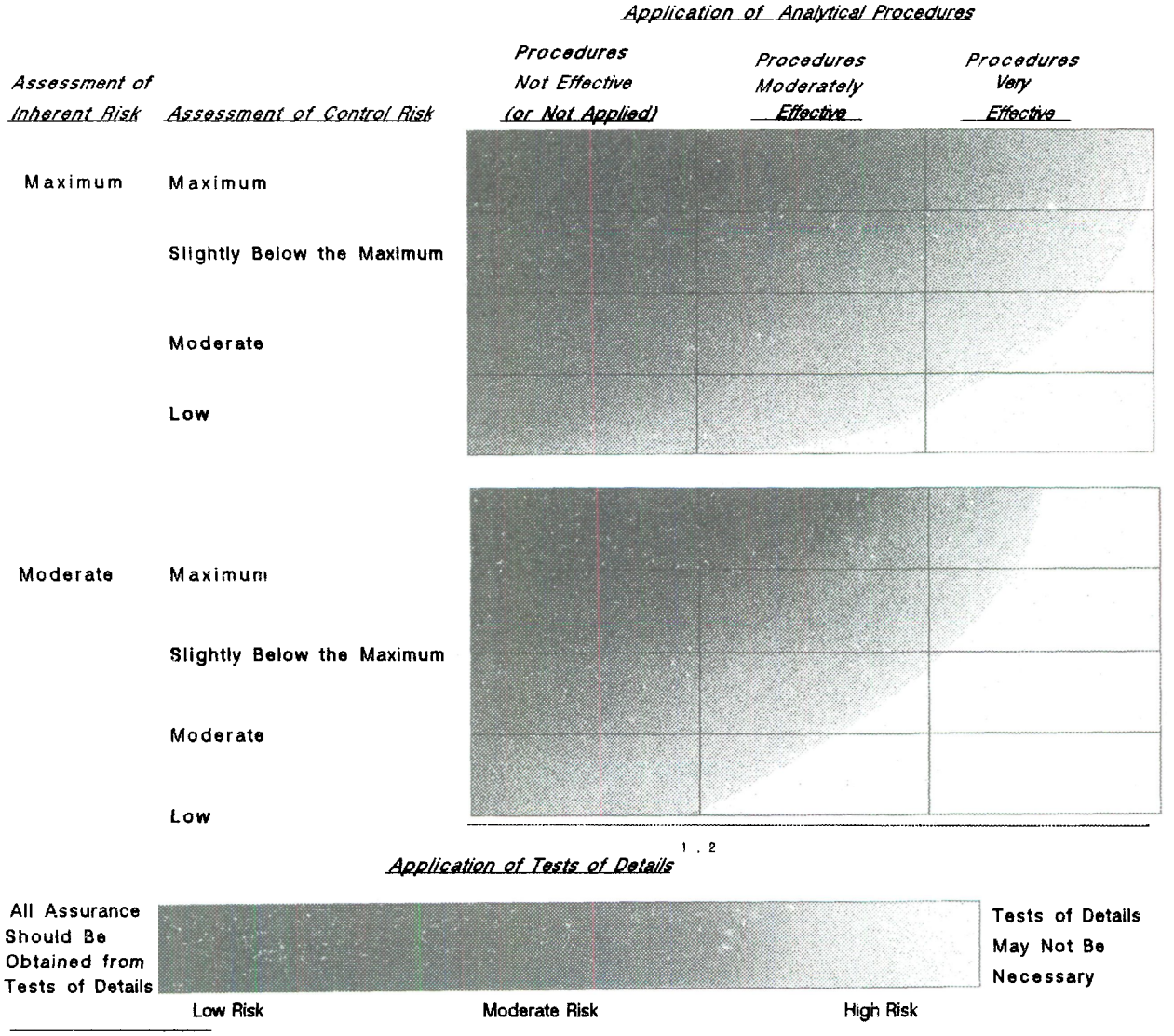
4.13 *For example, in Ownco, Inc. the auditor identified control structure policies and procedures involving the owner-manager's review and approval of sales orders and subsequent review of aged trial balances, along with the bookkeeper's procedures to follow up on unmatched documents. In response to a control risk assessment of moderate for the completeness of sales and receivables (exhibit B-5), the auditor limited tests of completeness to substantive analytical procedures involving a monthly comparison, by product line, of the current year's sales and gross profit margins with the same information for the prior year (that is, the analytical procedures were very effective in detecting possible material misstatements), and performed cutoff tests at year end.*

4.14 Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes. (See the table in figure 4-5.) Depending on the assessed levels of inherent and control risks, if the auditor performs effective analytical procedures as substantive tests, substantive tests of details may be eliminated. However, if analytical procedures are not considered to be effective, detection risk for tests of details ranges from very low to high. *For example, Vinco's auditors assessed control risk for the existence assertion related to accounts receivable at low (exhibit D-6). Nonetheless, analytical procedures and other substantive tests were performed (although the extent of those procedures was limited and most were performed at an interim date).*

FIGURE 4-5

RELATING DECISIONS ABOUT INHERENT RISK AND CONTROL RISK TO DECISIONS ABOUT DETECTION RISK ASSOCIATED WITH ANALYTICAL PROCEDURES AND TESTS OF DETAILS (for assertions related to significant account balances)

After assessing inherent and control risks, the auditor should consider the appropriate audit strategy including substantive analytical procedures and tests of details to restrict detection risk to an appropriate level.



1 The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The expected effectiveness effectiveness of analytical procedures in identifying potential misstatements depends on, among other things, (a) the nature of the assertion, (b) the plausibility and predictability of the relationship, (c) the availability and reliability of the data used to develop the expectation, and (d) the precision of the expectation.

2 As the shading moves from darker to lighter, the audit evidence needed from tests of details decreases. The lightest shading indicates that few or no tests of details are needed. When sampling is applied the allowable risk of incorrect acceptance would be appropriately decreased.

4.15 Figure 4-6 provides a more detailed illustration of how the auditor's control risk assessment may affect judgments about the nature, timing, or extent of substantive tests of the existence assertion for inventory. For purposes of this example, inventory represents a significant account balance amounting to 30 percent of total assets. It is located at three manufacturing plants comprising 50 percent, 30 percent, and 20 percent of the total. Inherent risk with respect to the existence assertion is judged to be high because of high turnover and susceptibility to shrinkage.

4.16 The audit procedures included in the illustration do not include tests of controls that would be required to support the assessed levels of control risk stated in the example. As discussed in chapter 3, the lower the control risk assessment, the greater the assurance that evidential matter should provide about the effectiveness of design and operation of the internal control structure. Some of the audit procedures included in the illustration may be designed appropriately as dual-purpose tests.[2] The auditor should consider whether the evidence obtained from the dual-purpose tests is sufficient to support the planned assessed level of control risk. If the evidence does not support the planned assessed level of control risk, the auditor should reassess control risk and revise substantive tests to restrict detection risk to an appropriate level.

Judgments About the Nature of Substantive Tests

4.17 Figure 4-5 illustrates the interrelationships among assessments of inherent risk, control risk, and judgments about substantive tests. The choice of whether to apply analytical procedures as substantive tests depends on their cost and effectiveness compared to the cost and effectiveness of tests of details. Judgments about the nature, timing, and extent of substantive tests of details reflected in figure 4-5 assume that analytical procedures performed as substantive tests are moderately effective in detecting misstatements that may be material. These analytical procedures might include, for example, an analysis comparing inventory turnover statistics for each location with prior periods and industry experience (for example, industry norms). Figure 4-5 provides an illustration of only one level of detection risk associated with analytical procedures. The auditor might perform more (or less) effective analytical procedures as substantive tests that would allow the detection risk associated with substantive tests of details to increase (or decrease).

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2 In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of a test of details of transactions performed as a substantive test is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction.

Judgments About the Timing of Substantive Tests

4.18 Tests of controls to support a lower assessed level of control risk may support a decision to modify the timing of substantive tests. In figure 4-6, as the evidence of an effective internal control structure supports a lower control risk assessment, the timing of certain substantive tests is illustrated as being performed at other than the balance-sheet date. SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AICPA, *Professional Standards*, vol. 1, AU sec. 313), indicates that control risk need not be assessed below the maximum to have a reasonable basis for extending audit conclusions from an interim date to the balance-sheet date; however, if the auditor assesses control risk at the maximum during the remaining period, the auditor should consider whether the effectiveness of certain of the substantive tests to cover that period will be impaired.

Judgments About the Extent of Substantive Tests

4.19 For some audit assertions for some accounts, it is efficient to assess control risk at the maximum. For example, for long-term debt it may be efficient to confirm all notes payable outstanding at year end. For accounts such as accounts receivable or inventory, however, it may be more efficient to reduce the extent of testing based on evidential matter supporting a control risk assessment below the maximum. As illustrated in figure 4-6, the extent of tests of details decreases as control risk decreases (assuming that inherent risk and the risk associated with analytical procedures is held constant).

4.20 The auditor's assessment of control risk below the maximum may affect the selection of key items for audit and may affect the auditor's decision about an appropriate risk of incorrect acceptance when the auditor decides to use audit sampling.

4.21 The auditor frequently selects key items for audit based on their monetary value (all items in excess of a stated monetary amount). Key items may also be selected based on the risk of material misstatement. For example, when testing inventory prices, the auditor may choose to test key items defined as those where prices have changed significantly from prior periods. Based on a particular risk characteristic, the auditor may divide a population into two or more groups, and audit one group based on a higher assessed level of control risk than that assessed for the other group. *Young Fashions, Inc. had problems with high personnel turnover in the Texas division (exhibit C-1). The auditor may choose to test transactions and balances from that one location based on an assessed level of control risk slightly below the maximum, and test the remainder of the population based on a lower assessed level of control risk.*

4.22 In other circumstances, the auditor may select key items based on materiality considerations and select a sample from the remaining population based on a uniform assessment of control risk. As the assessed level of control risk decreases, the acceptable level of detection risk increases and the auditor may, for example, define key items differently or use smaller samples.

FIGURE 4-6

IMPACT OF CONTROL RISK ASSESSMENT ON DESIGN OF SUBSTANTIVE TESTS OF DETAILS -- AN ILLUSTRATION

Control Risk Assessment[2]	*Resulting Level of Detection Risk*	*Design of Substantive Tests of Details for the Existence Assertion for Inventory*[1]		
		Nature	*Timing*	*Extent*
Maximum[2,5]	Low[3,4]	—Observation of inventories • Observe client count procedures • Auditor's control of count sheets or tag numbers used and unused • Auditor's recounts (i.e., "test counts")	—At the balance sheet date	—All three plants • Sufficient staff to observe counts of all significant inventory classes • For significant inventory classes • Extensive tests of details[9]
		—Tests of compilation • Arithmetic accuracy • Prices • Tieing in test counts and auditor-controlled count sheets or tag numbers used and unused • Review book to physical adjustment	—As of the balance sheet date	—All three plants • Extensive tests of details[9]
		—Cutoff tests • Shipping • Receiving	—As of the balance sheet date	—All three plants
Slightly below maximum[2,6]	Low[3,4]	—Same as above	—Same as above	—Same as above, except that extent of observation and other tests of details might be reduced slightly because of lower control risk[9]
Moderate[2,7]	Moderate[3,4]	—Observation of inventories • Observe client count procedures • Auditor's control of count sheets or tag numbers used and unused • Auditor's recounts (i.e., "test counts")	—At the inventory date (two months before year end)	—Two plants—to be determined based on size • Fewer staff to observe counting • For selected departments or areas • Moderate extent of tests of details[9]
		—Tests of compilation • Review book to physical adjustment • Arithmetic accuracy • Prices • Tieing in test counts and auditor-controlled count sheets or tag numbers used and unused	—As of the inventory date	—For the inventories observed • Moderate extent of tests of details[9]
		—Cutoff tests • Shipping • Receiving	—As of inventory date	—For the inventories observed
		—Test inventory transactions from inventory date to balance sheet date • Vouch purchases to and from perpetual records • Vouch sales to and from perpetual records	—At or near the balance sheet date and/or the inventory date	—For the inventories observed • Moderate extent of tests of details[9]

		—Substantive procedures for the inventories not observed[11]	—At or near the balance sheet date and/or the inventory date	—Sufficient to reduce the risk of undetected error to moderate[11]
Low[2,8]	High[3,4]	—Observation of cyclical inventory count procedures, including auditor's recounts (i.e., "test counts")	—Selected dates throughout the year	—All three plants or two of the three plants • Small number of staff • Representative tests of details[9]
		—Tests of compilation • Arithmetic accuracy • Prices • Agreeing results of cyclical counts to perpetual records	—Throughout the year	—All three plants or two of the three plants • Representative tests of details[9,10] • Representative selection of items counted by the auditor or selected from items counted by the client[9]
		—Cutoff tests • Shipping • Receiving	—Throughout the year	—All three plants or two of the three plants • Representative tests of details[9,10]
		—Test inventory transactions from inventory date to balance sheet date • Vouch purchases to and from perpetual records • Vouch sales to and from perpetual records	—Throughout the year	—All three plants or two of the three plants • Representative tests of details[9,10]

[1]Inventories are 30 percent of total assets. They are located at three manufacturing plants comprising 50 percent, 30 percent, and 20 percent of the total.

[2]The assessed level of control risk is related to the assurance obtained from evidential matter about the effectiveness of the design and operation of internal control structures policies and procedures. The audit procedures included in the illustration do not include tests of controls that are required to obtain sufficient audit evidence about design and operating effectiveness to support the assessed levels of control risk stated in the illustration. However, some of the audit procedures included in the illustration may be appropriately designed as dual purpose tests, in which evidence about operating effectiveness of controls is obtained concurrently with obtaining substantive evidence about the financial statement assertions.

[3]For purposes of the designations of detection risk as *low, moderate,* and *high* in the illustration, inherent risk to the existence assertion for inventories is judged to be *high* because of the high turnover and susceptibility to *shrinkage* and these designations are intended to be consistent with figure 4–5.

[4]For purposes of the designations of detection risk as *low, moderate,* and *high* in the illustration, analytical procedures applied by the auditor as substantive tests are considered to be moderately effective in providing substantive audit evidence relative to the existence assertion for inventories, and these designations are intended to be consistent with figure 4–5.

[5]The entity maintains perpetual records, and there is a history of significant book-to-physical adjustments. Physical inventories at all three plants are taken at year end. There is limited documentation of procedures to be used by the entity in taking the physical inventories, which, in the past, has resulted in confusion and frequent errors by the count teams.

[6]The entity maintains perpetual records, and there is a history of significant book-to-physical adjustments. Physical inventories at all three plants are taken at year end. Procedures to be used by the entity in taking the physical inventories are well designed and documented and, in the past, have been effectively carried out with relatively few errors by the count teams.

[7]The entity maintains perpetual records, and there is a history of minor book-to-physical adjustments. Physical inventories at all three plants are taken two months prior to year end. Procedures to be used by the entity in taking the physical inventories are well-designed and documented and, in the past, have been effectively carried out.

[8]The entity maintains perpetual records and there is a history of minor book-to-physical adjustments. Physical inventories at each of the three plants are taken on a cyclical basis throughout the year. Procedures used by the entity in these cyclical physical counts are well-designed and documented and, in the past, have been effectively carried out.

[9]An example of an approach to selecting the extent of tests of details is presented in the table in figure 4–5.

[10]With respect to the audit objectives relating to compilation and cutoff, the entity has effective control procedures. The auditor's understanding of these control procedures is the basis for a planned control risk assessment of *low* with respect to those objectives. Tests of these controls may be designed as dual purpose tests.

[11]Other substantive procedures applied to inventories not observed might be selected in a variety of ways and are not specifically listed in the illustration. Examples include tests of details, such as vouching purchases and sales to and from the perpetual records; adjusting the extent of the tests of details of inventories that are observed upward to obtain the same extent of tests, in total, that would have resulted had inventories at all locations been observed (assuming that the inventories not observed are similar to those observed, are subject to the same control policies and procedures and that the related inherent risk is the same), and analytical procedures.

APPENDIX A

THE RELATIONSHIP OF

THE AUDITOR'S CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE

TO OTHER AUDIT JUDGMENTS AND PROCEDURES

A.1 In a financial statement audit, the auditor's consideration of the internal control structure affects other decisions made throughout the audit. This appendix discusses other Statements on Auditing Standards with which the auditor should have familiarity to understand the second standard of fieldwork and provides a perspective on the relationship of the auditor's consideration of the internal control structure to other audit considerations.

THE RELATIONSHIP OF OTHER STATEMENTS ON AUDITING STANDARDS TO THE SECOND STANDARD OF FIELDWORK

AUDIT RISK

A.2 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol.1, AU sec. 312) and SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AICPA, *Professional Standards*, vol.1, AU sec. 316), provide professional guidance on the following:

- Audit risk
- The auditor's responsibility for detecting and reporting errors and irregularities and providing reasonable assurance that the financial statements are free of material misstatements
- The auditor's consideration of the risk of material misstatement at the financial statement level and at the account balance and transaction class level

A.3 SAS No. 47 discusses audit risk and requires the auditor to evaluate control risk when planning the audit. Audit risk[1] is the risk that the

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1 In addition to audit risk, the auditor is also exposed to loss or injury to his or her professional practice from litigation, adverse publicity, or other events arising in connection with financial statements that he or she has audited and reported on. This exposure is present even though the auditor has performed his or her audit in accordance with generally accepted auditing standards and has reported appropriately on those financial statements. Even if an auditor assesses this exposure as low, he or she should not perform less extensive procedures than would otherwise be appropriate under generally accepted auditing standards.

auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.[2] At the account-balance or class-of-transactions level, audit risk consists of (a) the risk (consisting of inherent risk and control risk) that the balance or class contains misstatements that could be material to the financial statements when aggregated with misstatements in other balances or classes and (b) the risk (detection risk) that the auditor will not detect such misstatements. The discussion that follows describes audit risk in terms of three component risks. The way the auditor considers these component risks and combines them involves professional judgment and depends on his or her audit approach.

- o Inherent risk is the susceptibility of an assertion to a material misstatement, assuming that there were no related internal control structure policies or procedures.

- o Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures.

- o Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

A.4 SAS No. 53 explains the auditor's responsibility for detecting errors and irregularities. The auditor should assess the risk that errors and irregularities may cause the financial statements to contain a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that

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2 This definition of audit risk does not include the risk that the auditor might erroneously conclude that the financial statements are materially misstated. In such a situation, he or she would ordinarily reconsider or extend his auditing procedures and request that the client perform specific tasks to reevaluate the appropriateness of the financial statements. These steps would ordinarily lead the auditor to the correct conclusion. This definition also excludes the risk of an inappropriate reporting decision unrelated to the detection and evaluation of misstatements in the financial statements, such as an inappropriate decision regarding the form of the auditor's report because of an uncertainty or limitation on the scope of the audit.

are material to the financial statements.[3,4] The auditor should consider the risk of material misstatement both at the financial statement level (including an assessment of the risk of management misrepresentation) and at the account balance or transaction class level.

A.5 Figure A-1 depicts the combined guidance that is developed from SAS Nos. 47, 53, and 55, provides some examples of inherent and control risk attributes that the auditor might consider, and denotes the audit decisions that might be affected. Inherent and control risks are not controlled by the auditor; rather, they are characteristics of the entity and are assessed by the auditor. After assessing inherent risk and control risk, the auditor considers a number of choices when designing and executing audit procedures.

A.6 An assessment of the risk of material misstatements should be made during planning. The factors considered in assessing risk should be considered in combination to make an overall judgment (SAS No. 53, paragraph 10). The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for the expected conduct and scope of the audit, and degree of professional skepticism applied. For example, the auditor may decide to limit or expand the number of locations to visit during the audit after considering the following factors:

- o Materiality of operations at a location
- o The nature of the operations at a location
- o Sensitivity of operating results to economic changes
- o Turnover of key management
- o Effectiveness of budgeting system to monitor performance

A.7 The auditor considers inherent and control risks at the account balance and transaction class level because these risks directly affect the nature, timing, and extent of audit procedures. For example, the auditor may find recent employee turnover in the accounts receivable area, no formal training of new personnel, and liberal credit-granting policies. The auditor may respond by performing extensive substantive tests of the existence and

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3 The concept of reasonable assurance is recognized in the third standard of fieldwork: "Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under audit" and is discussed in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), and SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350).

4 The auditor's responsibility for detecting misstatements resulting from illegal acts, as defined in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), having a direct and material effect on the determination of financial statement amounts is the same as that for other errors and irregularities.

FIGURE A-1

Illustration of the Audit Risk Concept

	Example Attributes Considered by the Auditor		Responses by the Auditor
	Inherent Risk	Control Risk	Detection Risk
Financial Statement Level	* Profitability relative to the industry * Sensitivity of operating results to economic factors * Going concern problems * Nature, cause, and amount of known and likely mistatements detected in the prior audit * Management turnover * Management reputation * Management accounting skills	* Business planning, budgeting, and monitoring of perfromance * Management attitude and actions regarding financial reporting * Management consultation with auditors * Management concern about external influences * Audit committee * Internal audit function * Personnel policies and procedures * Effectiveness of the accounting system	* Overall Audit Strategy * Number of locations * Significant balances or transaction classes * Degree of Professional Skepticism * Staffing * Levels of supervision and review
Account Balance or Transaction Class Level (including assessment for individual assertions)	* Difficult to audit accounts or transactions * Contentious or difficult accounting issues * Susceptibility to misappropriation * Complexity of calculations * Extent of judgment related to assertions * Sensitivity of valuations to economic factors * Nature, cause, and amount of known and likely mistatements detected in the prior audit	* Effectiveness of the accounting system * Personnel policies and procedures * Adequacy of accounting records * Segregation of duties * Adequacy of safeguards over assets and records (including software) * Independent checks on performance	* Substantive analytical procedures and tests of details * Nature of tests * Timing of tests * Extent of tests

Auditors consider the types of factors presented above; however it is not necessary to categorize such factors by type of risk.

valuation of accounts receivable at year end to obtain reasonable assurance that possible material misstatements are detected in the audit process.[5]

A.8 Audit risk -- assessing inherent and control risks and designing an audit plan to achieve an appropriate level of detection risk -- is a concept that is applied throughout the audit, both in developing an overall audit strategy and in planning specific audit procedures.

ASSERTIONS AND EVIDENTIAL MATTER

A.9 Most of the auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in the financial statements. SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), presents assertions as representations by management that are embodied in financial statement components. In obtaining evidential matter in support of financial statement assertions, the auditor develops specific audit objectives in light of those assertions. There is not necessarily a one-to-one relationship between audit objectives and audit procedures.

A.10 Assertions are classified in SAS No. 31 according to the following broad categories:

- Existence or occurrence. Reported assets and liabilities of the entity exist at the balance sheet date, and transactions reported in the income statement actually occurred during a given period
- Completeness. All transactions and accounts that should be presented in the financial statements are so included, and there are no undisclosed assets, liabilities, or transactions
- Rights and obligations. The company owns and has title to assets, and liabilities are the obligations of the company
- Valuation or allocation. The assets and liabilities are valued properly and the revenues and expenses are measured properly
- Presentation and disclosure. The assets, liabilities, revenues, and expenses are properly classified, described, and disclosed in the financial statements

A.11 The auditor should assess control risk in terms of assertions for material components of the financial statements. Some auditors accomplish this assessment by identifying internal control structure policies and procedures and relating them to audit objectives for account balances or transaction classes. SAS No. 55 does not preclude or require any specific approach as long as control risk is ultimately assessed at the assertion level.

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5 The auditor should also consider the aggregate of misstatements that, taken together, could cause the financial statements to be materially misstated.

AUDIT SAMPLING AND TESTS OF CONTROLS

A.12 The decision to apply audit sampling to tests of controls is a matter of professional judgment. For many tests of controls, sampling does not apply. Procedures performed to obtain an understanding of the internal control structure sufficient to plan an audit do not involve sampling.[6] Sampling generally is not applicable to tests of internal control structure policies or procedures that depend primarily on appropriate segregation of duties or that otherwise provide no documentary evidence of performance. In addition, sampling may not apply to tests of certain documented internal control structure policies or procedures. Sampling may not apply to tests directed toward obtaining evidence about the design or operation of the control environment or the accounting system (for example, inquiry or observation of explanations of variances from budgets when the auditor does not desire to estimate the rate of deviation from the prescribed control structure policy or procedure).

A.13 The auditor may choose to apply sampling to tests of the control environment (such as tests of the work of internal auditors) or to tests of certain documented control procedures (such as control procedures related to changes to existing computer programs and systems), for the purpose of estimating the rate of deviation from prescribed policies or procedures. SAS No. 39 discusses the auditor's considerations when sampling is used for tests of controls.

THE RELATIONSHIP OF THE AUDITOR'S CONSIDERATION OF THE INTERNAL CONTROL STRUCTURE TO OTHER AUDIT JUDGMENTS AND PROCEDURES

A.14 The objective of a financial statement audit is to express an opinion on whether such financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows, in conformity with generally accepted accounting principles. To accomplish this objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements.

A.15 Figure A-2 presents a view of the way in which the assessment of inherent and control risks influences some basic audit judgments and procedures in the process of forming an opinion on the financial statements taken as a whole. This is merely one depiction of the considerations involved in an audit. This figure is neither intended to be a complete description of every step involved in reaching an opinion on the financial statements nor to imply a specific sequencing of steps in the performance of an audit. In addition, the judgments and procedures outlined in the figure are not discrete and may overlap. For example, an auditor may consider

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6 The auditor often plans to perform tests of controls concurrently with obtaining an understanding of the internal control structure for the purpose of estimating the rate of deviations from the prescribed internal control structure policies and procedures, as to either the rate of such deviations or monetary amount of the related transactions. Sampling, as defined in SAS No. 39, applies to such tests of controls.

FIGURE A-2

The Relationship of the Auditor's Consideration of Internal Control Structure to Other Audit Considerations

[Appendix A paragraph numbers in italics]

Consider Risk of Material Misstatement at the Financial Statement Level

* Obtain an understanding of the entity's business and indusry *[A.16 - A.17]*
* Make preliminary judgments about materiality *[A.18]*
* Perform analytical procedures *[A.19]*
* Obtain an understanding of the internal control structure relevant to the development of an overall audit strategy *[A.20]*
* Consider factors that affect the risk of material misstatement at the financial statement level *[A.21-A.23]*
* Develop an overall audit plan
  * Engagement staffing and extent of supervision *[A.24-.25]*
  * Overall audit strategy for the expected conduct and scope of the audit *[A.26]*
  * Degree of professional skepticism *[A.27-.28]*

Consider Risk of Material Misstatement at the Account Balance and Class of Transactions Level

* Consider preliminary audit strategy for some or all assertions (and related audit objectives) applicable to significant account balances and classes of transactions *[A.29]*
* Obtain an understanding of the internal control structure relevant to the design of audit procedures *[A.30]*
* Obtain evidence about the operating effectiveness of relevant internal control structure policies and procedures and assess risk for relevant assertions *[A.31]*
  * Procedures to obtain the sufficient understanding
  * Planned tests of controls
* Reevaluate preliminary audit strategy *[A.32 - A.33]*
  * Consider a further reduction in the assessed level of control risk
  * Consider whether the assessed level of control risk supports the level of substantive tests
* Design audit procedures to reflect the auditor's determination of the appropriate level of detection risk *[A.34]*
  * Nature of substantive procedures
  * Timing of substantive procedures
  * Extent of substantive procedures

Execute Balance of Audit Plan

* Perform substantive tests *[A.35]*
* Complete overall review *[A.36]*
  * Perform analytical procedures
  * Evaluate fair presentation of the financial statements in accordance with generally accepted accounting principles
* Form an opinion on the financial statements *[A.37]*

NOTE: *This figure is neither intended to present the only conceptual way to view an audit nor to* imply a specific sequencing of audit steps in the performance of an audit.

inherent and control risks at the financial statement level and at the account balance or transaction class level simultaneously. Further, the auditor may revise assessments of inherent and control risks (based on information discovered as a result of performing audit tests) and reconsider their effect on audit strategy or procedures throughout the audit.

RISK OF MATERIAL MISSTATEMENTS IN THE FINANCIAL STATEMENTS

Understanding the Entity's Business and Industry

A.16 SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311), provides guidance on the auditor's understanding of the entity's business and the industry in which it operates. This understanding assists the auditor in --

- o Assessing the risk of material misstatements in the financial statements.
- o Making a judgment about the understanding of the entity's internal control structure necessary to plan the audit.
- o Designing tests of controls and substantive tests.

This knowledge ordinarily includes --

- o The nature of the entity's business, types of products and services, capital structure, related parties, locations, and production, distribution and compensation methods.
- o Matters affecting the industry in which the entity operates, such as economic conditions, government regulations, changes in technology, accounting practices common to the industry, and competitive conditions.
- o Profitability of the entity relative to the industry, sensitivity of operating results to economic factors, and rate of change in the entity's industry.

A.17 Knowledge of an entity's business is ordinarily obtained through experience with the entity or its industry and inquiry of personnel of the entity. Working papers from prior years may contain useful information about the nature of the business, organizational structure, operating characteristics, and transactions that may require special consideration. Other sources an auditor might consult include AICPA accounting and audit guides, industry publications, financial statements of other entities in the industry, textbooks, periodicals, and individuals knowledgeable about the industry.

Preliminary Judgment about Materiality for Audit Purposes

A.18 SAS No. 22 and SAS No. 47 require the auditor, in planning the audit, to consider, among other matters, a preliminary judgment about materiality

levels for audit purposes.[7] Financial statements are considered to be materially misstated when they contain misstatements whose effect, individually or in the aggregate, is important enough to cause a reasonable user to conclude that they are not presented fairly in conformity with generally accepted accounting principles. The auditor's consideration of materiality is a matter of professional judgment, and is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

Analytical Procedures

A.19 SAS No. 56, *Analytical Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 329), states that the purpose of applying analytical procedures in planning the audit is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain evidential matter for specific account balances or transaction classes. To accomplish this, analytical procedures used in planning the audit should focus on --

- o Enhancing the auditor's understanding of the client's business and transactions and events that have occurred since the last audit date.
- o Identifying areas that may represent specific risks relevant to the audit.

Performing analytical procedures during audit planning assists the auditor in developing an overall audit strategy, including a preliminary audit strategy for significant assertions related to material account balances and transaction classes.

Understanding of the Internal Control Structure Relevant to Initial Planning Decisions

A.20 The auditor's understanding of an entity's control environment, accounting system, and control procedures contributes significant information to the assessment of risk of material misstatements in the financial statements. Control environment elements (such as management's philosophy and operating style, management control methods, or personnel policies and procedures) have a bearing on the control consciousness of the organization, which in turn affects the overall risk of material misstatement in the financial statements. Assessing the risk of material misstatements in the financial statements requires an understanding of the accounting system and control procedures relevant to decisions about the development of an overall audit strategy. An understanding of the accounting systems and control procedures may influence the auditor's initial planning decisions about such matters as the number of locations to visit and account balances likely to require adjustment. For example, development of an overall audit strategy often requires an understanding of how computer activities are organized, the availability of data supporting financial statement transactions and balances, and the impact of computer

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7 SAS No. 47 states that the auditor's preliminary judgments about materiality levels may or may not be quantified.

processing on the reliability and accuracy of financial statement information. In addition, understanding that many supporting documents are at remote locations, while computer records are in a central location, may influence the auditor's decisions about the extent of understanding and planned testing of computer control procedures.

Considering Factors That Affect the Risk of Material Misstatement

A.21 An assessment of the risk of material misstatment should be made during audit planning. The auditor's understanding of the internal control structure should either heighten or mitigate the auditor's concern about the risk of material misstatements. The factors considered in assessing risk should be considered in combination to make an overall judgment; the presence of some factors in isolation would not necessarily indicate increased risk. Factors such as management characteristics, operating and industry characteristics, or engagement characteristics[8] may be considered.

A.22 The size, complexity, and ownership characteristics of the entity have a significant influence on the risk factors considered to be important. For example, for a large entity, the auditor would ordinarily give consideration to factors that constrain improper conduct by senior management, such as the effectiveness of the board of directors, the audit committee or others with equivalent authority and responsibility, and the internal audit function. Consideration would also be given to the measures taken to enforce a formal code of conduct and the effectiveness of the budgeting or responsibility reporting system. For a small entity, some of these matters might be considered inapplicable or unimportant, particularly if the auditor's past experience with the entity has been that effective owner-manager or trustee involvement creates a good control environment. The auditor should assess the risk of management misrepresentation by reviewing information obtained about risk factors and the internal control structure.[9]

A.23 The auditor should consider the effect of the matters described in this section on the overall audit strategy and the expected conduct and scope of the audit.

Overall Audit Plan

A.24 The auditor's overall judgment about the level of risk in an engagement may affect engagement staffing, extent of supervision, overall strategy for expected conduct and scope of audit, and degree of professional skepticism applied.

A.25 The experience and training of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the level of risk for the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement.

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8 SAS No. 53, paragraph 10, provides additional guidance on factors the auditor should consider.

9 SAS No. 53, paragraph 12, provides examples of these risk factors.

A.26 In planning the overall audit strategy, the auditor should consider the risk of material misstatement in significant account balances and transaction classes. When the risk of material misstatement is considered high, the auditor needs more assurance from substantive tests to restrict detection risk to an acceptable level. For example, a high risk of material misstatement may affect decisions about balances, transaction classes, lines of business, or the number of locations that need audit attention, or the need to perform audit tests as of year end.

A.27 The auditor should apply professional skepticism in evaluating the evidential matter necessary to express an opinion on the financial statements. The auditor neither assumes that management is dishonest nor assumes unquestioned honesty. Rather, the auditor recognizes that conditions observed and evidential matter obtained, including information from prior audits, need to be objectively evaluated to determine whether the financial statements are free of material misstatement.

A.28 Whenever the auditor has reached a conclusion that there is significant risk of material misstatement of the financial statements, the auditor reacts in one or more ways. The auditor should consider this assessment in determining the nature, timing, or extent of procedures, assigning staff, or requiring appropriate levels of supervision. The auditor may identify specific transactions involving senior management and confirm the details with appropriate external parties and review in detail all material accounting entries prepared or approved by senior management. The auditor should consider whether accounting policies are acceptable in the circumstances. When evaluation at the financial statement level indicates significant risk, the auditor requires more or different evidence to support material transactions than would be the case in the absence of such risk.

RISK ASSESSMENT AT THE ACCOUNT BALANCE AND TRANSACTION CLASS LEVEL

Consider Preliminary Audit Strategy for Significant Assertions Applicable to Material Account Balances and Transaction Classes

A.29 The auditor's ultimate objective in planning and performing a financial statement audit is to reduce audit risk to an appropriately low level. Because of the interrelationships between inherent risk, control risk, and detection risk, the auditor often will be able to choose between several possible audit approaches for an assertion applicable to a material account balance or transaction class. When considering a preliminary audit strategy for an assertion, the auditor makes an overall judgment about the audit approach that will reduce audit risk to an appropriately low level as well as considers audit efficiency. (The auditor's preliminary audit strategy is discussed in greater detail in chapter 2, paragraphs 2.2-2.8.)

Understanding the Internal Control Structure Relevant to the Design of Audit Procedures

A.30 The auditor's understanding of the internal control structure may depend on his or her judgments about a preliminary audit strategy. The flowchart presented in figure 1-2 recognizes two different audit strategies, each of which may be used for one or more of the following assertions:

- o Obtain an understanding that is sufficient to plan a primarily substantive approach (chapter 2, paragraphs 2.13-2.63).

- o Obtain an understanding sufficient to plan a lower assessed level of control risk. This strategy places more emphasis on planning and performing tests of controls, and less emphasis on substantive tests (chapter 2, paragraphs 2.64-2.87).

Obtaining Evidence About the Operating Effectiveness of Relevant Internal Control Structure Policies and Procedures and Assessing Risk for Relevant Assertions

A.31 For some assertions, the auditor may consider a strategy of obtaining the understanding considered sufficient to plan a primarily substantive approach. Even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. (Chapter 3 discussed and provided examples of how procedures performed to obtain the understanding may be tests of controls. If the planned assessed level of control risk is lower than that which may be supported by procedures performed to obtain the understanding for a primarily substantive approach, the auditor should plan to perform tests of controls to support the desired control risk assessment. Chapter 3 also discussed and provided examples of the assurance provided by tests of controls to support a lower assessed level of control risk.)

Reevaluate the Preliminary Audit Strategy

A.32 The auditor should consider the implications of evidence obtained from analytical procedures and tests of controls on planned risk assessments. This may cause a modification or refinement of substantive tests that would result in a more effective or efficient audit. For example, evidence of inconsistent application of a control procedure may cause the auditor to revise a planned control risk assessment and reconsider preliminary decisions about the nature, timing, or extent of substantive tests to be performed.

A.33 The auditor may decide to perform additional tests of controls relevant to certain assertions after assessing the evidence provided by tests of controls already performed. If additional evidential matter is available, and it would improve audit efficiency to support a further reduction in the assessed level of control risk (and therefore plan a higher level of detection risk when designing substantive procedures for particular assertions), the auditor may perform additional tests of controls. (Chapter 4, paragraph 4.2, provided a discussion of the auditor's reevaluation of the preliminary audit strategy.)

Design Audit Procedures to Reflect the Auditor's Determination of an Appropriate Level of Detection Risk

A.34 The auditor's conclusions about control risk may affect the subsequent design of the nature, timing, and extent of substantive tests (chapter 4, paragraphs 4.10-4.22).

EXECUTION OF THE BALANCE OF THE AUDIT PLAN

Perform Substantive Tests

A.35 The auditor performs substantive tests to detect material misstatements in an account balance, transaction class, or disclosure components of the financial statements. When a difference between the accounting records and the underlying facts and circumstances is found, the auditor should consider whether it is indicative of material errors or irregularities, the quantitative and qualitative implications, and the implications related to previous inherent and control risk assessments.

Overall Review

A.36 In the overall review, the auditor considers the adequacy of evidence and evaluates the overall fair presentation in the financial statements. The auditor reads the financial statements and notes and considers the sufficiency and competence of evidence gathered, performs analytical procedures, and considers unusual or unexpected balances or relationships not previously identified. Results of the overall review stage may indicate that additional evidence may be needed.

Form an Opinion on the Financial Statements

A.37 When, in the auditor's judgment, sufficient, and competent evidence has been obtained, an opinion on the financial statements taken as a whole can be formed.

APPENDIX B

A COMPARISON OF SAS NO. 55

WITH PRIOR PROFESSIONAL STANDARDS ON

THE AUDITOR'S STUDY AND EVALUATION OF INTERNAL CONTROL

B.1 SAS No. 55 was issued to help increase audit effectiveness. More specifically, its objectives are twofold:

- To broaden and clarify the auditor's responsibility to study and evaluate internal control in an audit
- To incorporate auditing concepts that have been articulated in auditing standards issued subsequent to the issuance of SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 320)

B.2 This appendix highlights some of the concepts presented in SAS No. 55 and compares them with SAS No. 1, AU 320, *The Auditor's Study and Evaluation of Internal Control* and other Statements on Auditing Standards.

PURPOSE OF THE AUDITOR'S UNDERSTANDING

SAS NO. 55

B.3 When the Auditing Standards Board (ASB) issued SAS No. 55, it concluded that in many audits the auditor could plan a more effective audit with a broader understanding of the elements of an entity's internal control structure than was required by the minimum study and evaluation of internal control required by AU 320. The internal control structure comprises --

- The control environment.
- The accounting system.
- Control procedures.

B.4 Because an entity's internal control structure significantly affects planning matters, SAS No. 55 expands the auditor's responsibility to obtain a sufficient understanding of the internal control structure to plan the audit. That is, the auditor should obtain an understanding of the control environment, the accounting system, and control procedures sufficient to --

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatements.
- Design substantive tests.

This knowledge is needed to plan the audit, regardless of the planned assessed level of control risk.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.5 The purpose of the review of the system was to obtain sufficient knowledge and understanding about the accounting system and the internal accounting control system to --

(a) Make a determination of whether there were internal accounting control procedures that may have provided a basis for reliance thereon in determining the nature, extent, and timing of substantive tests.

(b) Aid the auditor in designing substantive tests in the absence of such reliance.

SCOPE OF THE AUDITOR'S UNDERSTANDING

SAS NO. 55

B.6 SAS No. 55 broadens the knowledge that the auditor should have about the internal control structure. SAS No. 55 identifies elements of the control environment that might assist the auditor in evaluating the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of internal controls. SAS No. 55 also clarifies that the auditor's understanding of the accounting system should include --

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

After considering the knowledge of the control environment and the accounting system, the auditor uses professional judgment to determine the knowledge of control procedures considered sufficient to plan the audit.

B.7 In making a judgment about the necessary understanding of the internal control structure the auditor considers --

- o Knowledge from previous audits.
- o The understanding of the industry in which the entity operates.
- o Assessments of inherent risk.
- o Judgments about materiality.
- o The complexity and sophistication of the entity's operations and systems (including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized control procedures)

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.8 In AU 320 the preliminary phase of the review of the internal accounting control system was designed to provide the auditor with an understanding of the control environment and the flow of transactions through the accounting system. AU 320, however, provided little explicit guidance on what should be included in this understanding.

B.9 If, after the completion of the preliminary phase of the review, the auditor concluded that further study and evaluation were unlikely to justify any restriction of substantive tests, the auditor could discontinue further study and evaluation of the internal accounting control system.

DOCUMENTATION OF THE AUDITOR'S UNDERSTANDING

SAS NO. 55

B.10 SAS No. 55 requires auditors to document their understanding of an entity's control environment, accounting system, and control procedures, regardless of the assessed level of control risk. The auditor's documentation of the internal control structure should provide evidence that a sufficient understanding was acquired to plan the audit (or to support a lower planned assessed level of control risk).

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.11 If the auditor decided not to rely on the system to restrict substantive tests, documentation was limited to a record of the reasons for deciding not to extend the review. Auditors were not required to document their understanding of the control environment or accounting system.

B.12 If the auditor planned to rely on the system, the extent of the auditor's documentation of the review depended on --

- o His or her anticipated reliance on internal accounting controls.
- o The nature of the entity's system.
- o The entity's documentation of that system.

The auditor should have documented his or her understanding of the system and the basis for his or her conclusion that the internal accounting control procedures on which he or she intended to rely were suitably designed to provide reasonable assurance that those procedures would prevent or detect particular types of misstatements concerning particular classes of transactions or balances.

RECOGNITION OF UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE FROM PRIOR AUDITS

SAS NO. 55

B.13 SAS No. 55 explicitly recognizes that knowledge from prior audits may be used to obtain the required understanding of the internal control structure. This does not lower the requirement to obtain an understanding of the internal control structure sufficient to plan the audit. Rather, it recognizes that the auditor can consider knowledge from prior audits when determining the procedures necessary to obtain a current understanding of the control structure.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.14 The auditor's understanding was obtained by a combination of previous experience with the entity, inquiry, observation, and reference to prior-year working papers, client-prepared descriptions of the system, or other appropriate documentation. AU 320 did not provide explicit guidance on the role of knowledge from prior audits in the study and evaluation of internal accounting controls.

DEGREES OF CONTROL RISK ASSESSMENT VERSUS RELY/DON'T RELY

SAS NO. 55

B.15 The auditor may assess control risk for an assertion at the maximum or at any level below the maximum. The greater the assurance obtained from tests of controls about the effectiveness of the design and operation of relevant internal control structure policies or procedures, the further the auditor may be able to assess control risk below the maximum.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.16 AU 320 was issued before the concepts of assessing control risk and financial statement assertions were established in auditing standards. Under AU 320, not all auditors relied on internal accounting controls. Other auditors viewed the control risk assessment as a continuum and, for example, assessed control risk in terms of substantial, moderate, or no reliance on internal accounting controls.

RISK ASSESSMENT FOR AUDIT ASSERTIONS

SAS NO. 55

B.17 For material account balances and transaction classes, the auditor assesses control risk for the following significant assertions:

- o Existence and occurrence
- o Completeness
- o Rights and obligations
- o Valuation and allocation
- o Presentation and disclosure

The auditor may also assess control risk for audit objectives if they ultimately relate to assertions.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.18 AU 320 was issued prior to incorporating the audit risk model into the statements on auditing standards. As amended, AU 320 discussed assessing control risk for account balances and transaction classes and not assertions.

BASIS FOR THE CONTROL RISK ASSESSMENT

SAS NO. 55

B.19 In order to assess control risk below the maximum, the auditor should --

- o Identify specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- o Perform tests of controls to evaluate the effectiveness of such policies and procedures.

B.20 Tests of controls include procedures such as --

- o Inquiries of appropriate entity personnel.
- o Inspection of documents and reports indicating performance of the policy or procedure.
- o Observation of the application of the policy or procedure.
- o Reperformance of the application of the policy or procedure by the auditor.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.21 Under AU 320, the auditor performed compliance tests to provide reasonable assurance that the accounting control procedures are being applied as described. Tests of manual internal accounting control procedures required inspection of the related documents to --

(a) Obtain evidence in the form of signatures, initials, audit stamps, and the like.

(b) Indicate whether the procedures were performed, and by whom.

(c) Permit an evaluation of the propriety of their performance.

Tests of such procedures performed by a computer may have been made in a similar manner, provided that the computer produced visible evidence to --

(a) Verify that the procedures were in operation.

(b) Evaluate the propriety of their performance.

ASSESSING CONTROL RISK BASED ON THE UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE

SAS NO. 55

B.22 SAS No. 55 recognizes that the auditor can assess control risk below the maximum based on procedures performed to obtain the necessary understanding. Even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. The degree to which control risk can be assessed below the maximum depends on the assurance provided by such tests of controls. The evidence about operating effectiveness acquired while obtaining the necessary understanding generally results in a control risk assessment at or near the maximum.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.23 In AU 320, the preliminary review of the system of internal accounting control was separate and distinct from the performance of compliance tests. If the auditor did not perform compliance tests, then control risk was assessed at the maximum.

ASSESSING CONTROL RISK INCLUDES ASSESSING THE EFFECTIVENESS OF THE CONTROL ENVIRONMENT AND THE ACCOUNTING SYSTEM

SAS NO. 55

B.24 The auditor's assessment of control risk includes an assessment of the effectiveness of the design and operation of the control environment and

accounting system, as well as control procedures. The auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion, depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transactions classes and, therefore, can often affect many assertions. Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more direct the relationship, the more effective that policy or procedure may be in reducing control risk for that assertion.

PROFESSIONAL STANDARDS BEFORE SAS NO. 55

B.25 Prior to SAS No. 55, the auditor may have understood the control environment and the accounting system, but there was no provision for taking credit for positive aspects of these internal control structure elements when making a decision about reliance on internal accounting controls.

Statement on Auditing Standards

Issued by the Auditing Standards Board

April 1988

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AICPA American Institute of Certified Public Accountants

Consideration of the Internal Control Structure in a Financial Statement Audit

(Supersedes Statement on Auditing Standards No. 1, AICPA, **Professional Standards,** *vol. 1, AU sec. 320.)**

CONTENTS OF STATEMENT

*This Statement also supersedes SAS No. 1, *The Auditor's Study and Evaluation of Internal Control: Auditing Interpretations of AU Section 320* (AICPA, *Professional Standards*, AU sec. 9320.01-.06).

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1. This Statement provides guidance on the independent auditor's consideration of an entity's internal control structure in an audit of financial statements in accordance with generally accepted auditing standards.[1] It describes the elements of an internal control structure and explains how an auditor should consider the internal control structure in planning and performing an audit.

SUMMARY

2. An entity's internal control structure, for purposes of this Statement, consists of three elements: the control environment, the accounting system, and control procedures. In all audits, the auditor should obtain a sufficient understanding of each of the three elements to plan the audit by performing procedures to understand the design of policies and procedures relevant to audit planning and whether they have been placed in operation.

3. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements. The auditor may assess control risk at the maximum level (the greatest probability that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure) because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient. Alternatively, the auditor may obtain evidential matter about the effectiveness of both the design and operation of a policy or procedure that supports a lower assessed level of control risk. Such evidential matter may be obtained from tests of controls planned and performed concurrently with obtaining the understanding or from procedures performed to obtain the understanding that were not specifically planned as tests of controls.

[1]This Statement revises the second standard of fieldwork of the ten generally accepted auditing standards as follows:

> A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

4. After obtaining the understanding and assessing control risk, the auditor may desire to seek a further reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether evidential matter sufficient to support a further reduction is likely to be available and whether performing additional tests of controls to obtain such evidential matter would be efficient.

5. The auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk in determining the nature, timing, and extent of substantive tests for financial statement assertions.

STATEMENT

Elements of an Internal Control Structure

6. An entity's internal control structure consists of the policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved. Although the internal control structure may include a wide variety of objectives and related policies and procedures, only some of these may be relevant to an audit of the entity's financial statements. Generally, the policies and procedures that are relevant to an audit pertain to the entity's ability to record, process, summarize, and report financial data consistent with the assertions embodied in the financial statements.[2] Other policies and procedures, however, may be relevant if they pertain to data the auditor uses to apply auditing procedures. For example, policies and procedures pertaining to nonfinancial data that the auditor uses in analytical procedures, such as production statistics, may be relevant in an audit.

7. An entity generally has internal control structure policies and procedures that are not relevant to an audit and therefore need not be considered. For example, policies and procedures concerning the effectiveness, economy, and efficiency of certain management decision-

[2]The terms *financial statement assertions* and *assertions* are used throughout this Statement to refer to the five categories of management's assertions that are embodied in the account balance, transaction class, and disclosure components of financial statements as discussed in paragraphs 3 through 8 of Statement on Auditing Standards No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326.03-.08).

making processes, such as the appropriate price to charge for its products, or whether to make expenditures for certain research and development or advertising activities, although important to the entity, do not ordinarily relate to a financial statement audit.

8. For purposes of an audit of financial statements, an entity's internal control structure consists of the three following elements:

- The control environment
- The accounting system
- Control procedures

Dividing the internal control structure into these three elements facilitates discussion of its nature and how the auditor considers it in an audit. The auditor's primary consideration, however, is whether an internal control structure policy or procedure affects financial statement assertions rather than its classification into any particular category.

Control Environment

9. The control environment represents the collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include the following:

- Management's philosophy and operating style
- The entity's organizational structure
- The functioning of the board of directors and its committees, particularly the audit committee
- Methods of assigning authority and responsibility
- Management's control methods for monitoring and following up on performance, including internal auditing
- Personnel policies and practices
- Various external influences that affect an entity's operations and practices, *such as examinations by bank regulatory agencies*

The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity. (The control environment factors are discussed in greater detail in appendix A.)

Accounting System

10. The accounting system consists of the methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system gives appropriate consideration to establishing methods and records that will —

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Control Procedures

11. Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures have various objectives and are applied at various organizational and data processing levels. They may also be integrated into specific components of the control environment and the accounting system. Generally, they may be categorized as procedures that pertain to —

- Proper authorization of transactions and activities.
- Segregation of duties that reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure the proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.

- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparison of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

General Considerations

12. The applicability and importance of specific control environment factors, accounting system methods and records, and control procedures that an entity establishes should be considered in the context of—

- The entity's size.
- Its organization and ownership characteristics.
- The nature of its business.
- The diversity and complexity of its operations.
- Its methods of processing data.
- Its applicable legal and regulatory requirements.

For example, a formal written code of conduct or an organizational structure that provides for formal delegation of authority may be significant to the control environment of a large entity. However, a small entity with effective owner-manager involvement may not need a formal code or organizational structure. Similarly, a small entity with effective owner-manager involvement may not need extensive accounting procedures, sophisticated accounting records, or formal control procedures, such as a formal credit policy, information security policy, or competitive bidding procedures.

13. Establishing and maintaining an internal control structure is an important management responsibility. To provide reasonable assurance that an entity's objectives will be achieved, the internal control structure should be under ongoing supervision by management to determine that it is operating as intended and that it is modified as appropriate for changes in conditions.

14. The concept of reasonable assurance recognizes that the cost of an entity's internal control structure should not exceed the benefits that are expected to be derived. Although the cost-benefit relationship

is a primary criterion that should be considered in designing an internal control structure, the precise measurement of costs and benefits usually is not possible. Accordingly, management makes both quantitative and qualitative estimates and judgments in evaluating the cost-benefit relationship.

15. The potential effectiveness of an entity's internal control structure is subject to inherent limitations. Mistakes in the application of policies and procedures may arise from such causes as misunderstanding of instructions, mistakes in judgment, and personal carelessness, distraction, or fatigue. Furthermore, the policies and procedures that require segregation of duties can be circumvented by collusion among persons both within and outside the entity and by management override of certain policies or procedures.

Consideration of the Internal Control Structure in Planning an Audit

16. The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to —

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

17. Whether an internal control structure policy or procedure has been *placed in operation* is different from its *operating effectiveness*. In obtaining knowledge about whether policies, procedures, or records have been placed in operation, the auditor determines that the entity is using them. Operating effectiveness, on the other hand, is concerned with how the policy, procedure, or record was applied, the consistency with which it was applied, and by whom. This Statement does not require the auditor to obtain knowledge about operating effectiveness as part of the understanding of the internal control structure.

18. The auditor's understanding of the internal control structure may sometimes raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentations in the financial statements is such that an audit cannot be conducted. Concerns about the nature and extent of an entity's records may cause the auditor to conclude that it is unlikely that sufficient competent evidential matter will be available to support an opinion on the financial statements.

Understanding the Internal Control Structure

19. In making a judgment about the understanding of the internal control structure necessary to plan the audit, the auditor considers the knowledge obtained from other sources about the types of misstatements that could occur, the risk that such misstatements may occur, and the factors that influence the design of substantive tests. Other sources of such knowledge include previous audits and the understanding of the industry in which the entity operates. The auditor also considers his assessments of inherent risk, his judgments about materiality, and the complexity and sophistication of the entity's operations and systems, including whether the method of controlling data processing is based on manual procedures independent of the computer or is highly dependent on computerized controls. As an entity's operations and systems become more complex and sophisticated, it may be necessary to devote more attention to internal control structure elements to obtain the understanding of them that is necessary to design effective substantive tests. For example, when auditing past due loans of a financial institution that uses computer-produced reports of such loans, the auditor may be unable to design appropriate substantive tests without knowledge of the specific control procedures concerning the completeness and classification of loans.

Understanding of Control Environment

20. The auditor should obtain sufficient knowledge of the control environment to understand management's and the board of directors' attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of management's policies, procedures, and related actions rather than their form because management may establish appropriate policies and procedures but

not act on them. For example, a budgetary reporting system may provide adequate reports, but the reports may not be analyzed and acted on. Similarly, management may establish a formal code of conduct but act in a manner that condones violations of that code.

Understanding of Accounting System

21. The auditor should obtain sufficient knowledge of the accounting system to understand —

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated.
- The accounting records, supporting documents, machine-readable information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including how the computer is used to process data.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

Understanding of Control Procedures

22. Because some control procedures are integrated in specific components of the control environment and accounting system, as the auditor obtains an understanding of the control environment and accounting system, he is also likely to obtain knowledge about some control procedures. For example, in obtaining an understanding of the documents, records, and processing steps in the accounting system that pertain to cash, the auditor is likely to become aware of whether bank accounts are reconciled. The auditor should consider the knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether it is necessary to devote additional attention to obtaining an understanding of control procedures to plan the audit. Ordinarily, audit planning does not require an understanding of the control procedures related to each account balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to those components.

Procedures to Obtain Understanding

23. In obtaining an understanding of the internal control structure policies and procedures that are relevant to audit planning, the auditor should perform procedures to provide sufficient knowledge of the design of the relevant policies, procedures, and records pertaining to each of the three internal control structure elements and whether they have been placed in operation. This knowledge is ordinarily obtained through previous experience with the entity and procedures such as inquiries of appropriate management, supervisory, and staff personnel; inspection of entity documents and records; and observation of entity activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular policy or procedure, and the nature of the entity's documentation of specific policies and procedures.

24. For example, the auditor's prior experience with the entity may provide an understanding of its classes of transactions. Inquiries of appropriate entity personnel and inspection of documents and records, such as source documents, journals, and ledgers, may provide an understanding of the accounting records designed to process those transactions and whether they have been placed in operation. Similarly, in obtaining an understanding of the design of computer-programmed control procedures and whether they have been placed in operation, the auditor may make inquiries of appropriate entity personnel and inspect relevant systems documentation to understand control procedure design and may inspect exception reports generated as a result of such control procedures to determine that they have been placed in operation.

25. The auditor's assessments of inherent risk and judgments about materiality for various account balances and transaction classes also affect the nature and extent of the procedures performed to obtain the understanding. For example, the auditor may conclude that planning the audit of the prepaid insurance account does not require specific procedures to be included in obtaining the understanding of the internal control structure.

Documentation of Understanding

26. The auditor should document the understanding of the entity's internal control structure elements obtained to plan the audit. The form and extent of this documentation is influenced by the size and complexity of the entity, as well as the nature of the entity's internal control structure. For example, documentation of the understanding of the internal control structure of a large complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, documentation in the form of a memorandum may be sufficient. Generally, the more complex the internal control structure and the more extensive the procedures performed, the more extensive the auditor's documentation should be.

Consideration of the Internal Control Structure in Assessing Control Risk

27. Statement on Auditing Standards No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), states that most of the independent auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the assertions in such financial statements. These assertions are embodied in the account balance, transaction class, and disclosure components of financial statements and are classified according to the following broad categories:

- Existence or occurrence
- Completeness
- Rights and obligations
- Valuation or allocation
- Presentation and disclosure

In planning and performing an audit, an auditor considers these assertions in the context of their relationship to a specific account balance or class of transactions.

28. The risk of material misstatement[3] in financial statement assertions consists of inherent risk, control risk, and detection risk. Inherent risk is the susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures. Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the entity's internal control structure policies or procedures. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion.

29. Assessing control risk is the process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting material misstatements in the financial statements. Control risk should be assessed in terms of financial statement assertions. After obtaining the understanding of the internal control structure, the auditor may assess control risk at the maximum level for some or all assertions because he believes policies and procedures are unlikely to pertain to an assertion, are unlikely to be effective, or because evaluating their effectiveness would be inefficient.[4]

30. Assessing control risk at below the maximum level involves—

- Identifying specific internal control structure policies and procedures relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions.
- Performing tests of controls to evaluate the effectiveness of such policies and procedures.

31. In identifying internal control structure policies and procedures relevant to specific financial statement assertions, the auditor should consider that the policies and procedures can have either a pervasive effect on many assertions or a specific effect on an individual assertion,

[3] For purposes of this Statement, a material misstatement in a financial statement assertion is an error or irregularity as defined in SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, that either individually or when aggregated with other errors or irregularities in other assertions would be material to the financial statements taken as a whole.

[4] Control risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms that range, for example, from a maximum to a minimum. The term *maximum level* is used in this Statement to mean the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

depending on the nature of the particular internal control structure element involved. The control environment and accounting system often have a pervasive effect on a number of account balances or transaction classes and, therefore, can often affect many assertions. For example, the conclusion that an entity's control environment is highly effective may influence the auditor's decision about the number of an entity's locations at which auditing procedures are to be performed or whether to perform certain auditing procedures for some account balances or transaction classes at an interim date. Either decision affects the way in which auditing procedures are applied to specific assertions, even though the auditor may not have specifically considered each individual assertion that is affected by such decisions.

32. Conversely, some control procedures often have a specific effect on an individual assertion embodied in a particular account balance or transaction class. For example, the control procedures that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence assertion for the inventory account balance.

33. Internal control structure policies and procedures can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that policy or procedure may be in reducing control risk for that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing control risk for that assertion than policies and procedures more directly related to that assertion, such as matching shipping documents with billing documents.

34. Procedures directed toward either the effectiveness of the design or operation of an internal control structure policy or procedure are referred to as tests of controls. Tests of controls directed toward the effectiveness of the design of an internal control structure policy or procedure are concerned with whether that policy or procedure is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Tests to obtain such evidential matter ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports, and observation of the application of specific internal control structure policies and procedures. For entities with a complex internal control structure, the audi-

tor should consider that the use of flowcharts, questionnaires, or decision tables might facilitate the application of tests of design.

35. Tests of controls directed toward the operating effectiveness of an internal control structure policy or procedure are concerned with how the policy or procedure was applied, the consistency with which it was applied during the audit period, and by whom it was applied. These tests ordinarily include procedures such as inquiries of appropriate entity personnel, inspection of documents and reports indicating performance of the policy or procedure, observation of the application of the policy or procedure, and reperformance of the application of the policy or procedure by the auditor. In some circumstances, a specific procedure may address the effectiveness of both design and operation. However, a combination of procedures may be necessary to evaluate the effectiveness of the design or operation of an internal control structure policy or procedure.

36. The conclusion reached as a result of assessing control risk is referred to as the *assessed level of control risk.* In determining the evidential matter necessary to support a specific assessed level of control risk at below the maximum level, the auditor should consider the characteristics of evidential matter about control risk discussed in paragraphs 46 through 60. Generally, however, the lower the assessed level of control risk, the greater the assurance the evidential matter must provide that the internal control structure policies and procedures relevant to an assertion are designed and operating effectively.

37. The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for financial statement assertions. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the auditing procedures to be used to detect material misstatements in the financial statement assertions. Auditing procedures designed to detect such misstatements are referred to in this Statement as substantive tests.

38. As the acceptable level of detection risk decreases, the assurance provided from substantive tests should increase. Consequently, the auditor may do one or more of the following:

- Change the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the entity rather than tests directed toward parties or documentation within the entity.

- Change the timing of substantive tests, such as performing them at year end rather than at an interim date.
- Change the extent of substantive tests, such as using a larger sample size.

Documentation of the Assessed Level of Control Risk

39. In addition to the documentation of the understanding of the internal control structure discussed in paragraph 26, the auditor should document the basis for his conclusions about the assessed level of control risk. Conclusions about the assessed level of control risk may differ as they relate to various account balances or classes of transactions. However, for those financial statement assertions where control risk is assessed at the maximum level, the auditor should document his conclusion that control risk is at the maximum level but need not document the basis for that conclusion. For those assertions where the assessed level of control risk is below the maximum level, the auditor should document the basis for his conclusion that the effectiveness of the design and operation of internal control structure policies and procedures supports that assessed level. The nature and extent of the auditor's documentation are influenced by the assessed level of control risk used, the nature of the entity's internal control structure, and the nature of the entity's documentation of its internal control structure.

Relationship of Understanding to Assessing Control Risk

40. Although understanding the internal control structure and assessing control risk are discussed separately in this Statement, they may be performed concurrently in an audit. The objective of procedures performed to obtain an understanding of the internal control structure (discussed in paragraphs 23 through 25) is to provide the auditor with knowledge necessary for audit planning. The objective of tests of controls (discussed in paragraphs 34 through 35) is to provide the auditor with evidential matter to use in assessing control risk. However, procedures performed to achieve one objective may also pertain to the other objective.

41. Based on the assessed level of control risk the auditor expects to support and audit efficiency considerations, the auditor often plans to

perform some tests of controls concurrently with obtaining the understanding of the internal control structure. In addition, even though some of the procedures performed to obtain the understanding may not have been specifically planned as tests of controls, they may also provide evidential matter about the effectiveness of both the design and operation of the policies and procedures relevant to certain assertions and, consequently, serve as tests of controls. For example, in obtaining an understanding of the control environment, the auditor may have made inquiries about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances between budgeted and actual amounts. Although these procedures provide knowledge about the design of the entity's budgeting policies and whether they have been placed in operation, they may also provide evidential matter about the effectiveness of the design and operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses. In some circumstances, that evidential matter may be sufficient to support an assessed level of control risk that is below the maximum level for the presentation and disclosure assertions pertaining to expenses in the income statement.

42. When the auditor concludes that procedures performed to obtain the understanding of the internal control structure also provide evidential matter for assessing control risk, he should consider the guidance in paragraphs 46 through 60 in judging the degree of assurance provided by that evidential matter. Although such evidential matter may not provide sufficient assurance to support an assessed level of control risk that is below the maximum level for certain assertions, it may do so for other assertions and thus provide a basis for modifying the nature, timing, or extent of the substantive tests that the auditor plans for those assertions. However, such procedures are not sufficient to support an assessed level of control risk below the maximum level if they do not provide sufficient evidential matter to evaluate the effectiveness of both the design and operation of a policy or procedure relevant to an assertion.

Further Reduction in the Assessed Level of Control Risk

43. After obtaining the understanding of the internal control structure and assessing control risk, the auditor may desire to seek a further

reduction in the assessed level of control risk for certain assertions. In such cases, the auditor considers whether additional evidential matter sufficient to support a further reduction is likely to be available, and whether it would be efficient to perform tests of controls to obtain that evidential matter. The results of the procedures performed to obtain the understanding of the internal control structure, as well as pertinent information from other sources, help the auditor to evaluate those two factors.

44. In considering efficiency, the auditor recognizes that additional evidential matter that supports a further reduction in the assessed level of control risk for an assertion would result in less audit effort for the substantive tests of that assertion. The auditor weighs the increase in audit effort associated with the additional tests of controls that is necessary to obtain such evidential matter against the resulting decrease in audit effort associated with the reduced substantive tests. When the auditor concludes it is inefficient to obtain additional evidential matter for specific assertions, the auditor uses the assessed level of control risk based on the understanding of the internal control structure in planning the substantive tests for those assertions.

45. For those assertions for which the auditor performs additional tests of controls, the auditor determines the assessed level of control risk that the results of those tests will support. This assessed level of control risk is used in determining the appropriate detection risk to accept for those assertions and, accordingly, in determining the nature, timing, and extent of substantive tests for such assertions.

Evidential Matter to Support the Assessed Level of Control Risk

46. When the auditor assesses control risk at below the maximum level, he should obtain sufficient evidential matter to support that assessed level. The evidential matter that is sufficient to support a specific assessed level of control risk is a matter of auditing judgment. Evidential matter varies substantially in the assurance it provides to the auditor as he develops an assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads, all bear on the degree of assurance evidential matter provides.

47. These characteristics influence the nature, timing, and extent of the tests of controls that the auditor applies to obtain evidential matter about control risk. The auditor selects such tests from a variety of techniques such as inquiry, observation, inspection, and reperformance of a policy or procedure that pertains to an assertion. No one specific test of controls is always necessary, applicable, or equally effective in every circumstance.

Type of Evidential Matter

48. The nature of the particular policies and procedures that pertain to an assertion influences the type of evidential matter that is available to evaluate the effectiveness of the design or operation of those policies and procedures. For some policies and procedures, documentation of design or operation may exist. In such circumstances, the auditor may decide to inspect the documentation to obtain evidential matter about the effectiveness of design or operation.

49. For other policies and procedures, however, such documentation may not be available or relevant. For example, documentation of design or operation may not exist for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control procedures, such as segregation of duties or some control procedures performed by a computer. In such circumstances, evidential matter about the effectiveness of design or operation may be obtained through observation or the use of computer-assisted audit techniques to reperform the application of relevant policies and procedures.

Source of Evidential Matter

50. Generally, evidential matter about the effectiveness of the design and operation of policies and procedures obtained directly by the auditor, such as through observation, provides more assurance than evidential matter obtained indirectly or by inference, such as through inquiry. For example, evidential matter about the proper segregation of duties that is obtained by the auditor's direct personal observation of the individual who applies a control procedure generally provides more assurance than making inquiries about that individual. The auditor should consider, however, that the observed application of a policy or procedure might not be performed in the same manner when the auditor is not present.

51. Inquiry alone generally will not provide sufficient evidential matter to support a conclusion about the effectiveness of design or operation of a specific control procedure. When the auditor determines that a specific control procedure may have a significant effect in reducing control risk to a low level for a specific assertion, he ordinarily needs to perform additional tests to obtain sufficient evidential matter to support the conclusion about the effectiveness of the design or operation of that control procedure.

Timeliness of Evidential Matter

52. The timeliness of evidential matter concerns when it was obtained and the portion of the audit period to which it applies. In evaluating the degree of assurance that is provided by evidential matter, the auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of internal control structure policies and procedures for periods not subjected to such tests. In such circumstances, the auditor may decide to supplement these tests with other tests of controls that are capable of providing evidential matter about the entire audit period. For example, for a control procedure performed by a computer program, the auditor may test the operation of the control at a particular point in time to obtain evidential matter about whether the program executes the control effectively. The auditor may then perform tests of controls directed toward the design and operation of other control procedures pertaining to the modification and the use of that computer program during the audit period to obtain evidential matter about whether the programmed control procedure operated consistently during the audit period.

53. Evidential matter about the effective design or operation of internal control structure policies and procedures that was obtained in prior audits may be considered by the auditor in assessing control risk in the current audit. To evaluate the use of such evidential matter for the current audit, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the prior audits, the degree to which the effective design and operation of those policies and proce-

dures were evaluated, the results of the tests of controls used to make those evaluations, and the evidential matter about design or operation that may result from substantive tests performed in the current audit. The auditor should also consider that the longer the time elapsed since the performance of tests of controls to obtain evidential matter about control risk, the less assurance it may provide.

54. When considering evidential matter obtained from prior audits, the auditor should obtain evidential matter in the current period about whether changes have occurred in the internal control structure, including its policies, procedures, and personnel, subsequent to the prior audits, as well as the nature and extent of any such changes. Consideration of evidential matter about these changes, together with the considerations in the preceding paragraph, may support either increasing or decreasing the additional evidential matter about the effectiveness of design and operation to be obtained in the current period.

55. When the auditor obtains evidential matter about the design or operation of internal control structure policies and procedures during an interim period, he should determine what additional evidential matter should be obtained for the remaining period. In making that determination, the auditor should consider the significance of the assertion involved, the specific internal control structure policies and procedures that were evaluated during the interim period, the degree to which the effective design and operation of those policies and procedures were evaluated, the results of the tests of controls used to make that evaluation, the length of the remaining period, and the evidential matter about design or operation that may result from the substantive tests performed in the remaining period. The auditor should obtain evidential matter about the nature and extent of any significant changes in the internal control structure, including its policies, procedures, and personnel, that occur subsequent to the interim period.

Interrelationship of Evidential Matter

56. The auditor should consider the combined effect of various types of evidential matter relating to the same assertion in evaluating the degree of assurance that evidential matter provides. In some circumstances, a single type of evidential matter may not be sufficient to

evaluate the effective design or operation of an internal control structure policy or procedure. To obtain sufficient evidential matter in such circumstances, the auditor may perform other tests of controls pertaining to that policy or procedure. For example, an auditor may observe that programmers are not authorized to operate the computer. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with inquiries about the frequency and circumstances under which programmers may have access to the computer and may inspect documentation of past instances when programmers attempted to operate the computer to determine how such attempts were prevented or detected.

57. In addition, when evaluating the degree of assurance provided by evidential matter, the auditor should consider the interrelationship of an entity's control environment, accounting system, and control procedures. Although an individual internal control structure element may affect the nature, timing, or extent of substantive tests for a specific financial statement assertion, the auditor should consider the evidential matter about an individual element in relation to the evidential matter about the other elements in assessing control risk for a specific assertion.

58. Generally, when various types of evidential matter support the same conclusion about the design or operation of an internal control structure policy or procedure, the degree of assurance provided increases. Conversely, if various types of evidential matter lead to different conclusions about the design or operation of an internal control structure policy or procedure, the assurance provided decreases. For example, based on the evidential matter that the control environment is effective, the auditor may have reduced the number of locations at which auditing procedures will be performed. If, however, when evaluating specific control procedures, the auditor obtains evidential matter that such procedures are ineffective, he may reevaluate his conclusion about the control environment and, among other things, decide to perform auditing procedures at additional locations.

59. Similarly, evidential matter indicating that the control environment is ineffective may adversely affect an otherwise effective accounting system or control procedure for a particular assertion. For example, a control environment that is likely to permit unauthorized changes in a computer program may reduce the assurance provided by evidential matter obtained from evaluating the effectiveness of the

program at a particular point in time. In such circumstances, the auditor may decide to obtain additional evidential matter about the design and operation of that program during the audit period. For example, the auditor might obtain and control a copy of the program and use computer-assisted audit techniques to compare that copy with the program that the entity uses to process data.

60. An audit of financial statements is a cumulative process; as the auditor assesses control risk, the information obtained may cause him to modify the nature, timing, or extent of the other planned tests of controls for assessing control risk. In addition, information may come to the auditor's attention as a result of performing substantive tests or from other sources during the audit that differs significantly from the information on which his planned tests of controls for assessing control risk were based. For example, the extent of misstatements that the auditor detects by performing substantive tests may alter his judgment about the assessed level of control risk. In such circumstances, the auditor may need to reevaluate the planned substantive procedures, based on a revised consideration of the assessed level of control risk for all or some of the financial statement assertions.

Correlation of Control Risk With Detection Risk

61. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that material misstatements exist in the financial statements. The process of assessing control risk (together with assessing inherent risk) provides evidential matter about the risk that such misstatements may exist in the financial statements. The auditor uses this evidential matter as part of the reasonable basis for an opinion referred to in the third standard of field work, which follows:

> Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

62. After considering the level to which he seeks to restrict the risk of a material misstatement in the financial statements and the assessed levels of inherent risk and control risk, the auditor performs substantive tests to restrict detection risk to an acceptable level. As the

assessed level of control risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the substantive tests performed.

63. Although the inverse relationship between control risk and detection risk may permit the auditor to change the nature or the timing of substantive tests or limit their extent, ordinarily the assessed level of control risk cannot be sufficiently low to eliminate the need to perform any substantive tests to restrict detection risk for all of the assertions relevant to significant account balances or transaction classes. Consequently, regardless of the assessed level of control risk, the auditor should perform substantive tests for significant account balances and transaction classes.

64. The substantive tests that the auditor performs consist of tests of details of transactions and balances, and analytical procedures. In assessing control risk, the auditor also may use tests of details of transactions as tests of controls. The objective of tests of details of transactions performed as substantive tests is to detect material misstatements in the financial statements. The objective of tests of details of transactions performed as tests of controls is to evaluate whether an internal control structure policy or procedure operated effectively. Although these objectives are different, both may be accomplished concurrently through performance of a test of details on the same transaction. The auditor should recognize, however, that careful consideration should be given to the design and evaluation of such tests to ensure that both objectives will be accomplished.

Effective Date

65. This Statement is effective for audits of financial statements for periods beginning on or after January 1, 1990. Early application of the provisions of this Statement is permissible.

Appendix A

Control Environment Factors

1. This appendix discusses the control environment factors identified in paragraph 9.

Management Philosophy and Operating Style

2. Management philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following: management's approach to taking and monitoring business risks; management's attitudes and actions toward financial reporting; and management's emphasis on meeting budget, profit, and other financial and operating goals. These characteristics have a significant influence on the control environment, particularly when management is dominated by one or a few individuals, regardless of the consideration given to the other control environment factors.

Organizational Structure

3. An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. An organizational structure includes consideration of the form and nature of an entity's organizational units, including the data processing organization, and related management functions and reporting relationships. In addition, the organizational structure should assign authority and responsibility within the entity in an appropriate manner.

Audit Committee

4. An effective audit committee takes an active role in overseeing an entity's accounting and financial reporting policies and practices. The committee should assist the board of directors in fulfilling its fiduciary and accountability responsibilities and should help maintain a direct line of communication between the board and the entity's external and internal auditors.

Methods of Assigning Authority and Responsibility

5. These methods affect the understanding of reporting relationships and responsibilities established within the entity. Methods of assigning authority and responsibility include consideration of—

- Entity policy regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct.
- Assignment of responsibility and delegation of authority to deal with such matters as organizational goals and objectives, operating functions, and regulatory requirements.
- Employee job descriptions delineating specific duties, reporting relationships, and constraints.
- Computer systems documentation indicating the procedures for authorizing transactions and approving systems changes.

Management Control Methods

6. These methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management control methods include consideration of—

- Establishing planning and reporting systems that set forth management's plans and the results of actual performance. Such systems may include business planning; budgeting, forecasting, and profit planning; and responsibility accounting.
- Establishing methods that identify the status of actual performance and exceptions from planned performance, as well as communicating them to the appropriate levels of management.
- Using such methods at appropriate management levels to investigate variances from expectations and to take appropriate and timely corrective action.
- Establishing and monitoring policies for developing and modifying accounting systems and control procedures, including the development, modification, and use of any related computer programs and data files.

Internal Audit Function

7. The internal audit function is established within an entity to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures. Establishing an effective internal audit function includes consideration of its authority and reporting relationships, the qualifications of its staff, and its resources.*

*SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Auditor's Examination* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), provides guidance about factors that affect the auditor's consideration of the work of internal auditors in an audit.

Personnel Policies and Practices

8. These policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Personnel policies and practices include consideration of an entity's policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

External Influences

9. These are influences established and exercised by parties outside an entity that affect an entity's operations and practices. They include monitoring and compliance requirements imposed by legislative and regulatory bodies, such as examinations by bank regulatory agencies. They also include review and follow-up by parties outside the entity concerning entity actions. External influences are ordinarily outside an entity's authority. Such influences, however, may heighten management's consciousness of and attitude towards the conduct and reporting of an entity's operations and may also prompt management to establish specific internal control structure policies or procedures.

Appendix B

Glossary of Selected Terms and Concepts

Accounting system The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities.

Assertions Management representations that are embodied in the account balance, transaction class, and disclosure components of financial statements. They include (1) existence or occurrence, (2) completeness, (3) rights and obligations, (4) valuation or allocation, and (5) presentation and disclosure.

Assessed level of control risk The level of control risk the auditor uses in determining the detection risk to accept for a financial statement assertion and, accordingly, in determining the nature, timing, and extent of substantive tests. This level may vary along a range from maximum to minimum as long as the auditor has obtained evidential matter to support that assessed level.

Assessing control risk The process of evaluating the effectiveness of an entity's internal control structure policies and procedures in preventing or detecting misstatements in financial statement assertions.

Control environment The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies and procedures. Such factors include (1) management philosophy and operating style, (2) organizational structure, (3) the function of the board of directors and its committees, (4) methods of assigning authority and responsibility, (5) management control methods, (6) the internal audit function, (7) personnel policies and practices, and (8) external influences concerning the entity.

Control procedures The policies and procedures in addition to the control environment and accounting system that management has established to provide reasonable assurance that specific entity objectives will be achieved.

Control risk The risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by an entity's internal control structure policies or procedures.

Detection risk *The risk that the auditor will not detect a material misstatement* that exists in an assertion.

Inherent risk The susceptibility of an assertion to a material misstatement assuming there are no related internal control structure policies or procedures.

Internal control structure The policies and procedures established to provide reasonable assurance that specific entity objectives will be achieved.

Internal control structure policies and procedures relevant to an audit The policies and procedures in an entity's internal control structure that pertain to the entity's ability to record, process, summarize, and report financial data consistent with management's assertions embodied in the financial statements or that pertain to data the auditor uses to apply auditing procedures to financial statement assertions.

Maximum level of control risk The greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by an entity's internal control structure.

Operating effectiveness How an internal control structure policy or procedure was applied, the consistency with which it was applied, and by whom.

Placed in operation An entity is using an internal control structure policy or procedure.

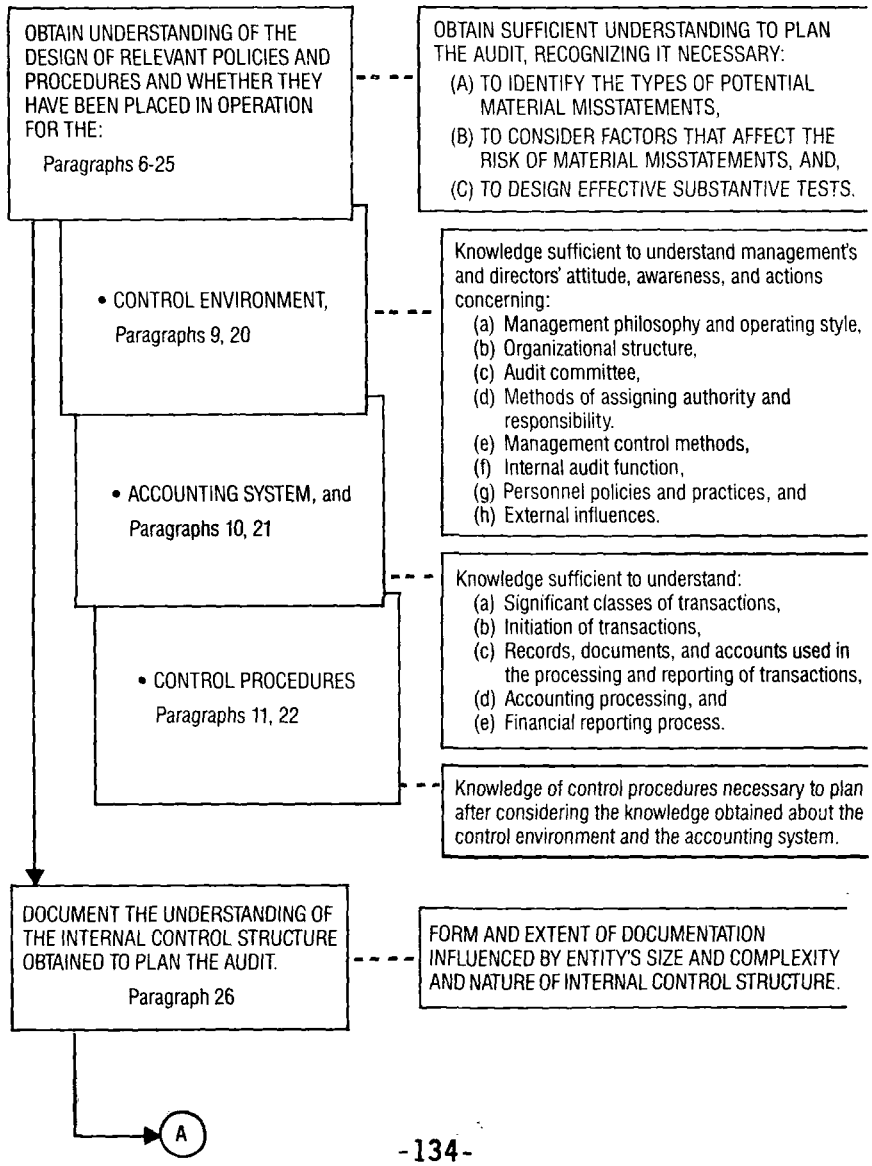
Substantive tests Tests of details and analytical procedures performed to detect material misstatements in the account balance, transaction class, and disclosure components of financial statements.

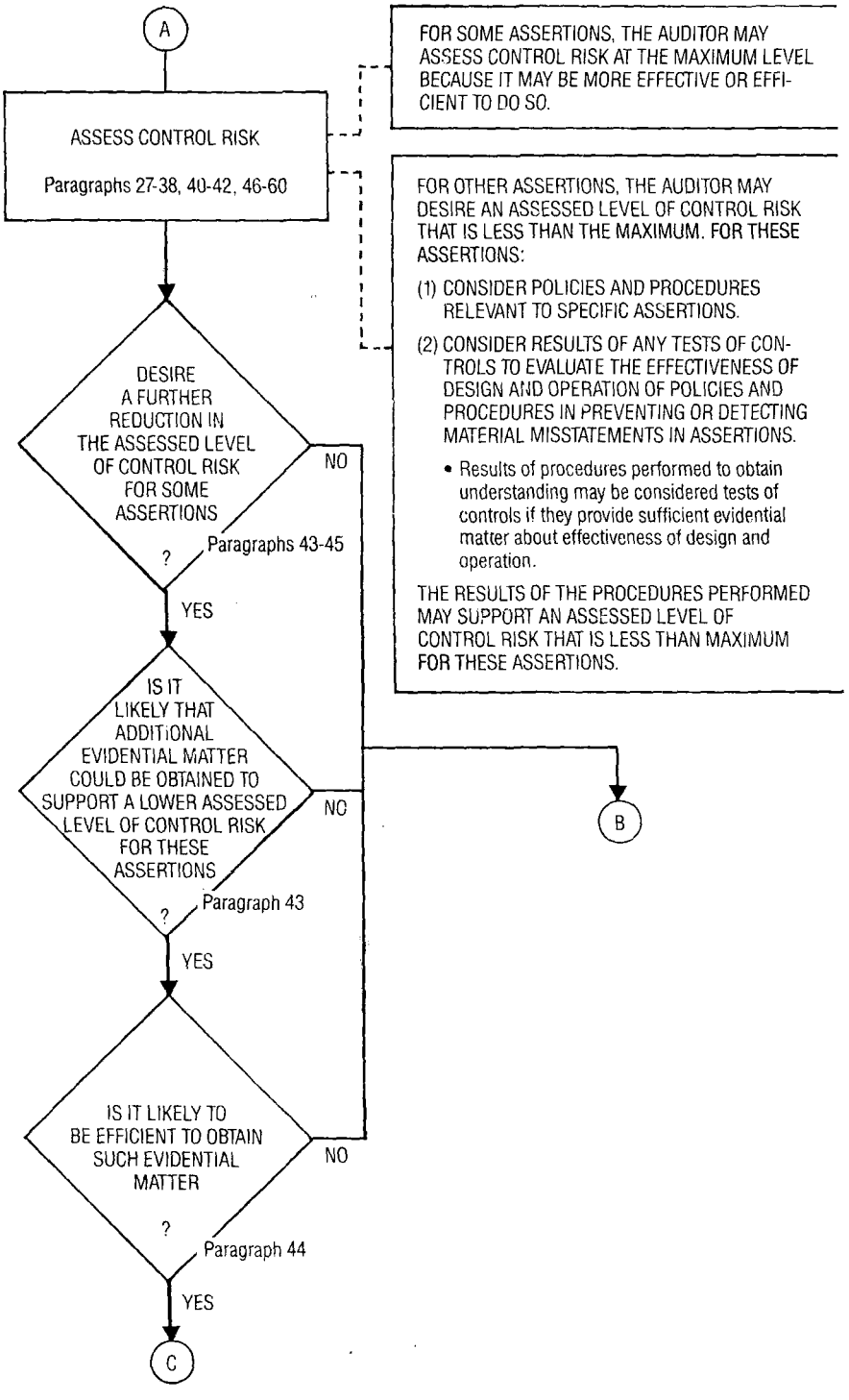
Tests of controls Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

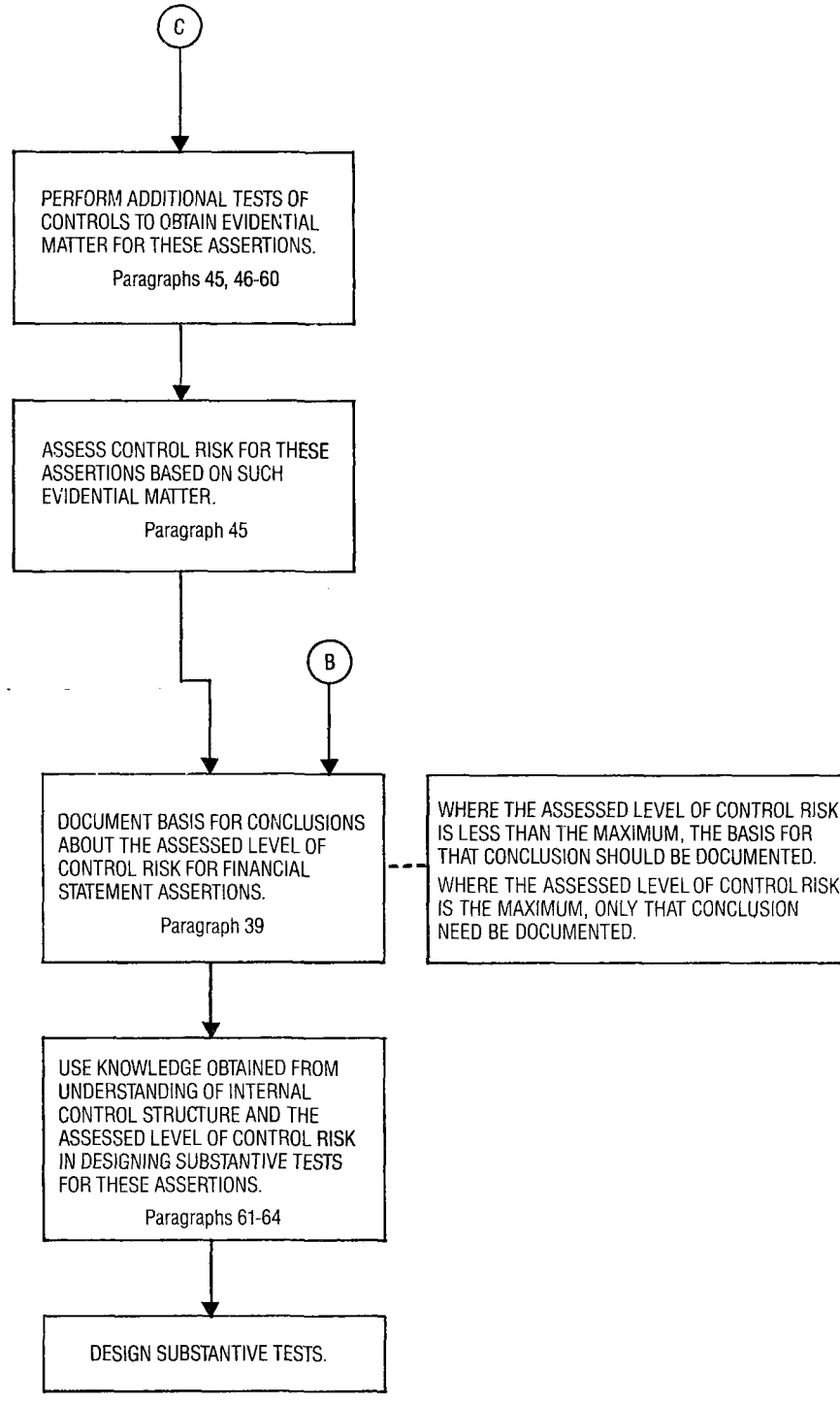
Understanding of the internal control structure The knowledge of the control environment, accounting system, and control procedures that the auditor believes is necessary to plan the audit.

Appendix C

FLOWCHART
CONSIDERATION OF THE INTERNAL CONTROL
STRUCTURE IN A FINANCIAL STATEMENT AUDIT




A
ASSESS CONTROL RISK
Paragraphs 27-38, 40-42, 46-60
FOR SOME ASSERTIONS, THE AUDITOR MAY ASSESS CONTROL RISK AT THE MAXIMUM LEVEL BECAUSE IT MAY BE MORE EFFECTIVE OR EFFICIENT TO DO SO.
FOR OTHER ASSERTIONS, THE AUDITOR MAY DESIRE AN ASSESSED LEVEL OF CONTROL RISK THAT IS LESS THAN THE MAXIMUM. FOR THESE ASSERTIONS:
(1) CONSIDER POLICIES AND PROCEDURES RELEVANT TO SPECIFIC ASSERTIONS.
(2) CONSIDER RESULTS OF ANY TESTS OF CONTROLS TO EVALUATE THE EFFECTIVENESS OF DESIGN AND OPERATION OF POLICIES AND PROCEDURES IN PREVENTING OR DETECTING MATERIAL MISSTATEMENTS IN ASSERTIONS.
• Results of procedures performed to obtain understanding may be considered tests of controls if they provide sufficient evidential matter about effectiveness of design and operation.
THE RESULTS OF THE PROCEDURES PERFORMED MAY SUPPORT AN ASSESSED LEVEL OF CONTROL RISK THAT IS LESS THAN MAXIMUM FOR THESE ASSERTIONS.
DESIRE A FURTHER REDUCTION IN THE ASSESSED LEVEL OF CONTROL RISK FOR SOME ASSERTIONS
NO
?
Paragraphs 43-45
YES
IS IT LIKELY THAT ADDITIONAL EVIDENTIAL MATTER COULD BE OBTAINED TO SUPPORT A LOWER ASSESSED LEVEL OF CONTROL RISK FOR THESE ASSERTIONS
NO
?
Paragraph 43
YES
IS IT LIKELY TO BE EFFICIENT TO OBTAIN SUCH EVIDENTIAL MATTER
NO
?
Paragraph 44
YES
B
C


C
PERFORM ADDITIONAL TESTS OF CONTROLS TO OBTAIN EVIDENTIAL MATTER FOR THESE ASSERTIONS.
Paragraphs 45, 46-60
ASSESS CONTROL RISK FOR THESE ASSERTIONS BASED ON SUCH EVIDENTIAL MATTER.
Paragraph 45
B
DOCUMENT BASIS FOR CONCLUSIONS ABOUT THE ASSESSED LEVEL OF CONTROL RISK FOR FINANCIAL STATEMENT ASSERTIONS.
Paragraph 39
WHERE THE ASSESSED LEVEL OF CONTROL RISK IS LESS THAN THE MAXIMUM, THE BASIS FOR THAT CONCLUSION SHOULD BE DOCUMENTED.
WHERE THE ASSESSED LEVEL OF CONTROL RISK IS THE MAXIMUM, ONLY THAT CONCLUSION NEED BE DOCUMENTED.
USE KNOWLEDGE OBTAINED FROM UNDERSTANDING OF INTERNAL CONTROL STRUCTURE AND THE ASSESSED LEVEL OF CONTROL RISK IN DESIGNING SUBSTANTIVE TESTS FOR THESE ASSERTIONS.
Paragraphs 61-64
DESIGN SUBSTANTIVE TESTS.

Appendix D

Other Selected Management Control Objectives

1. The concepts and terminology introduced in this Statement clarify and update former SAS No. 1, *The Auditor's Study and Evaluation of Internal Control* (AICPA, *Professional Standards*, vol. 1, AU sec. 320), by incorporating the concepts concerning audit evidence and audit risk that have evolved in practice and that have been established by Statements on Auditing Standards issued subsequent to that SAS. This appendix discusses some of the basic concepts in SAS No. 1 that are implicit in an internal control structure but that are not explicitly discussed in this Statement. Although these concepts have general application, the organizational and procedural means for applying them may differ considerably from case to case because of the variety of circumstances involved.

Management Objectives

2. Establishing and maintaining an internal control structure is an important management responsibility. In establishing specific internal control structure policies and procedures concerning an entity's ability to record, process, summarize, and report financial data that is consistent with management's assertions embodied in the financial statements, some of the specific objectives management may wish to consider include the following:

- Transactions are executed in accordance with management's general or specific authorization.
- Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements and (2) to maintain accountability for assets.
- Access to assets is permitted only in accordance with management's authorization.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Access to Assets

3. The objectives of safeguarding assets requires that access to assets be limited to authorized personnel. In this context, access to assets includes both

direct physical access and indirect access through the preparation or processing of documents that authorize the use or disposition of assets. Access to assets is required in the normal operations of a business and, therefore, limiting access to authorized personnel is the maximum feasible constraint. The number and competence of personnel to whom access is authorized should be influenced by the nature of the assets and the related susceptibility to loss through errors and irregularities. Limitation of direct access to assets requires appropriate physical segregation and protective equipment or devices.

Comparison of Recorded Accountability With Assets

4. The purpose of comparing recorded accountability with assets is to determine whether the actual assets agree with the recorded accountability. Typical examples of this comparison include cash and securities counts, bank reconciliations, and physical inventories.

5. If the comparison reveals that the assets do not agree with the recorded accountability, it provides evidence of unrecorded or improperly recorded transactions. The converse, however, does not necessarily follow. For example, agreement of cash count with the recorded balance does not provide evidence that all cash received has been properly recorded.

6. This illustrates an unavoidable distinction between fiduciary and recorded accountability: the former arises immediately upon acquisition of an asset; the latter arises only when the initial record of the transaction is prepared.

7. As to assets that are susceptible to loss through errors or irregularities, the comparison with recorded accountability should be made independently. The frequency with which such comparison should be made for the purpose of safeguarding assets depends on the nature and amount of the assets involved and the cost of making the comparison. For example, it may be reasonable to count cash daily but not reasonable to take a physical inventory at that interval. However, a daily inventory of products in the custody of route salesmen, for example, may be practicable as a means of determining their accountability for sales. Similarly, the value and vulnerability of some products may make frequent complete inventories worthwhile.

8. The frequency with which comparison of recorded accountability with assets should be made for the purpose of achieving reliability of the records for preparing financial statements depends on the materiality of the assets and their susceptibility to loss through errors and irregularities.

9. The action that may be appropriate with respect to any discrepancies revealed by the comparison of recorded accountability with assets will depend primarily on the nature of the asset, the system in use, and the amount and

cause of the discrepancy. Appropriate action may include adjustment of the accounting records, filing of insurance claims, revision of procedures, or administrative action to improve the performance of personnel.

The Statement entitled Consideration of the Internal Control Structure in a Financial Statement Audit *was adopted by the assenting votes of seventeen members of the board, of whom two, Messrs. Barber and Neebes, assented with qualification. Messrs. Barna, Clancy, Loebbecke and Ten Eyck dissented.*

Mr. Barber qualifies his assent to the issuance of this Statement because he believes the concept of a further reduction in the assessed level of control risk, starting in paragraph 43, is inconsistent with his perception of the audit process, wherein the auditor makes a preliminary assessment of the level of control risk based on his understanding of the internal control structure, gained primarily through his inquiry and observation procedures, and then performs audit procedures to validate that assessment if he intends to assess control risk at less than the maximum to restrict substantive tests. He also believes that the "further reduction" concept unnecessarily changes and confuses the well understood concept of "reliance on internal controls." Further, he believes that the Statement's relationship of the assessment of control risk directly to financial statement assertions is confusing, since he views the starting point for the auditor's control risk assessment as the relationship of controls to significant audit areas.

Mr. Neebes qualifies his assent because he believes the Statement fails to properly caution the auditor against placing undue reliance on the effectiveness of specific control procedures based solely on inquiry of client personnel and inspection of client-prepared documents. While he believes such procedures are important tests of controls, they ordinarily should not, in his opinion, be performed to the exclusion of reperformance or observation procedures if the auditor intends to assess control risk at a low level for a particular financial statement assertion. Mr. Neebes agrees with the statement in paragraph 50 that generally evidential matter obtained directly by the auditor provides more assurance than evidential matter obtained indirectly or by inference. He believes, however, that the implications of that statement should be explicitly stated in paragraph 51 in discussing the nature of tests ordinarily needed to conclude that a specific control procedure is effective in reducing control risk to a low level for a specific financial statement assertion.

Messrs. Barna, Clancy, Loebbecke, and Ten Eyck dissent because they have concerns that the Statement may not be consistently interpreted and appropriately applied in practice. They believe that the Statement should not be issued until it has been revised to resolve their concerns. Mr. Barna also believes that the Statement should have been re-exposed because, in his opinion, a number of significant changes were made to the exposure draft.

Mr. Clancy, in addition to his concern about the consistent interpretation and appropriate application of the Statement, believes that the Statement should increase responsibility regarding the auditor's consideration of an entity's internal control structure. He notes that the Statement includes two significant improvements to authoritative guidance by (1) recognizing that the auditor should obtain a sufficient understanding of each of the three elements of an

entity's internal control structure to plan the audit, and (2) recognizing that, in obtaining that understanding, the auditor considers knowledge obtained from previous audits. He believes, however, that those responsibilities should be extended to require the auditor to review and evaluate, as contrasted with obtain a sufficient understanding of, each of the three elements of the entity's internal control structure that management uses in operating and controlling the business and that the auditor considers significant. He further believes that the Statement as written is overly complex and that several sound and long-established concepts, such as reliance on internal control and compliance testing, which are well understood by auditors and management and are comparatively easy to explain to others, should not be eliminated.

Mr. Ten Eyck, in addition to his concern about the consistent interpretation and appropriate application of the Statement, believes that the Statement is ambiguous regarding the relationship between the assessment of control risk and the reduced level of control risk based on evidential matter obtained from the understanding of the internal control structure. He also believes the Statement does not clearly distinguish the operating effectiveness of an internal control structure policy or procedure from the placing in operation of such a policy or procedure. He further believes that insufficient guidance is provided about the procedures in general that are necessary to arrive at valid conclusions about control risk and that, in particular, inquiry is not defined nor, in his opinion, is meaningful guidance provided about its use as an audit procedure.

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Note: *Statements on Auditing Standards are issued by the Auditing Standards Board, the senior technical body of the Institute designated to issue pronouncements on auditing matters. Rule 202 of the Institute's Code of Professional Conduct requires compliance with these standards.*

EXHIBIT A-1

SUMMARY OF EXHIBITS

Note: The following exhibits illustrate the types of workpapers an auditor might prepare when obtaining the understanding of the internal control structure and assessing control risk in an audit. Italics are used throughout to illustrate information completed by the auditor.

Exhibit No.	Workpaper Ref.	Exhibit Description
A-2	-	Company Background Information
		Comparison of Accounting Systems for the Exhibited Companies
Ownco, Inc.		
B-1	Perm. File ICS-1	Memorandum documenting the understanding of the control environment
B-2	Perm. File ICS-2	Flowchart documenting the understanding of the accounting system and some control procedures for credit sales
B-3	Perm. File ICS-3	Memorandum documenting the understanding of the accounting system and some control procedures for cash receipts, and sales returns, adjustments, and credits
B-4	Perm. File ICS-4	Memorandum summarizing potential risks of material misstatement for revenue and cash receipts
B-5	CR-1	Memorandum summarizing control risk assessments below the maximum
B-6	C-2	Memorandum documenting tests of controls and specific control risk assessments below the maximum for sales and receivables
Young Fashions, Inc.		
C-1	IC-10	Questionnaire documenting understanding of the control environment
C-2	IC-20	Memorandum documenting the understanding of the accounting system and control procedures for sales transactions
C-3	IC-26	Flowchart documenting the understanding of the accounting system and control procedures for cash receipts
C-4	E-1	Memorandum summarizing the control risk assessment for sales and accounts receivable

EXHIBIT A-1
(Continued)

Exhibit No.	Workpaper Ref.	Exhibit Description
Vinco, Inc.		
D-1	-	Summary of workpapers documenting the understanding of the internal control structure
D-2	C-10	Control environment questionnaire
D-3	R-10	Understanding of accounting systems and control procedures
	R-40	Flowchart of accounting system billing function and control procedure questionnaire for the billing function
	R-60	Open-ended questionnaire for collection efforts
D-4	G-10	General EDP control questionnaire
D-5	-	Summary of test of controls workpapers
	C-30	Discussion of significant budget variations with management
	C-40	Review of internal audit work
	R-100	Tests of accounting system and control procedures for the billing function
	G-30	Review of documentation of new or significantly modified computer programs
	G-40	Tests of computer access control procedures
D-6	-	Summary of audit approach workpapers
	R-1	Summary of audit approach (existence, occurrence, and rights)
	R-2	Summary of audit approach (completeness)
	R-3	Summary of audit approach (valuation -- receivables are properly stated at their gross value)
	R-4	Summary of audit approach (valuation -- receivables are properly stated at net realizable value)
D-7	R-5	Upate of risk assessments for receivables and revenues

COMPARISON OF EXHIBITED COMPANIES

Company Description	*Ownco, Inc.*	*Young Fashions, Inc.*	*Vinco, Inc.*
Nature of business	Manufacturer of Plastic Worms	Apparel Manufacturer	Wine Importer and Distributor
Number of locations	1	3	8
Corporate structure	Single entity	Single entity	Single entity
Ownership	Sole owner	Nonpublic and closely held ownership	Public
Trading of common stock	None	None	NYSE
Control Structure			
Number of personnel			
- Top management	1	4	8
- Accounting dept.	2	10	35
- Total	30	200	500
Segregation of Duties	Limited	Good	Good
History of Adjustments	Typically relate to tax accrual, inventory, and closing adjustments	Typically relate to accounting estimates and cutoff	No adjustments required
Client control documentation	Nominal	Partial	Extensive and complete
Audit Committee	None	None	Yes, meets 3 times a year
Internal audit function	None	None	Internal auditors are qualified and perform work related to financial statements
Accounting System			
Computer hardware	Micro	Mid-range mini-computer	Mainframe

Company Description	*Owmco, Inc.*	*Young Fashions, Inc.*	*Vinco, Inc.*
Data processing	Centralized	Centralized	Centralized
Number of DP personnel	None	5	27
Revenue system	Batch	On-line entry, Batch update	On-line entry, Batch update
Revenue Transactions			
How is transaction initiated?	Sales order written by salesman and approved by owner-manager who closely monitors sales.	Sales order written by salesman and approved by credit manager.	Sales order written by salesman or sent by customer. Approval by computer program, which checks valid customer number and approves credit.
The accounting records, supporting documents, machine-readable information and specific accounts involved in the processing of transactions			
Sales order	Manual, no computer entry	Manual, enter in computer upon approval	Manual, enter in computer upon receipt
Shipping report, bill of lading, packing slip	Manual, no computer entry	Manual, enter quantities in computer when shipment is prepared. Computer-generated packing slip, manual bill of lading.	Computer-generated based on Daily Priced-Out Sales Order File, which includes scheduled shipment date.
Sales invoice	Manual entry of data. Computer-generated sales invoice	Customer and quantity data from packing slip. Prices in master file. Computer generated sales invoice.	Billing program generates sales invoice based on Daily Shipments File and Master-Price File.

Company Description	*Ownco, Inc.*	*Young Fashions, Inc.*	*Vinco, Inc.*
Machine-readable information	Cumulative Sales File Accounts Receivable Master File General Ledger Master File	Master-Price File Outstanding Transactions File Cumulative Sales File Accounts Receivable Master File General Ledger Master File	Customer Master File Master-Price File Daily Priced-Out Sales Order File Daily Shipments File Daily Cash Receipts File Month to Date Sales File Accounts Receivable Master File General Ledger Master File
Accounting processing	Computer processes invoices and posts transactions to journals, subsidiary ledgers, and G/L.		
Financial reporting process	Significant accounting services performed by auditor	No significant controls over financial reporting	Financial statement captions generated by general ledger system. No formal controls over financial statement drafting.

EXHIBIT B-1

WP INDEX *PERM. FILE ICS-1*

CLIENT *Ownco, Inc.* BALANCE SHEET DATE *12/31/x8*

Completed by:	*mlw*	Date:	*9/30/x5*	Reviewed by:	*jp*	Date:	*11/02/x5*
Updated by:	*mlw*	Date:	*9/15/x6*	Reviewed by:	*jp*	Date:	*10/29/x6*
Updated by:		Date:		Reviewed by:		Date:	
Updated by:		Date:		Reviewed by:		Date:	
Updated by:		Date:		Reviewed by:		Date:	

UNDERSTANDING OF THE CONTROL ENVIRONMENT

The Company manufactures plastic fishing worms at one location, and is managed by its sole owner, Ed Jones. Management of the company is dominated by Jones, who is responsible for marketing, purchasing, hiring, and approving major transactions. He has a good understanding of the business and the industry in which it operates. Jones has a moderate to conservative attitude toward business risks, the business has demonstrated consistent profitability, and because Jones considers lower taxes to be as important as financial results, he has a conservative attitude toward accounting estimates.

The Company's board of directors is composed of family members. The board is not expected to monitor the business or the owner-manager's activities.

Most of the significant accounting functions are performed by the bookkeeper, Pat Willis, and Jones' secretary, Chris Ross. Willis was hired by the company in 19X0, has a working knowledge of accounting fundamentals, and we have no reason to question Willis' competence. Willis regularly consults with our firm on unusual transactions, and past history indicates that it is rare for adjustments to arise from errors in the processing of routine transactions.

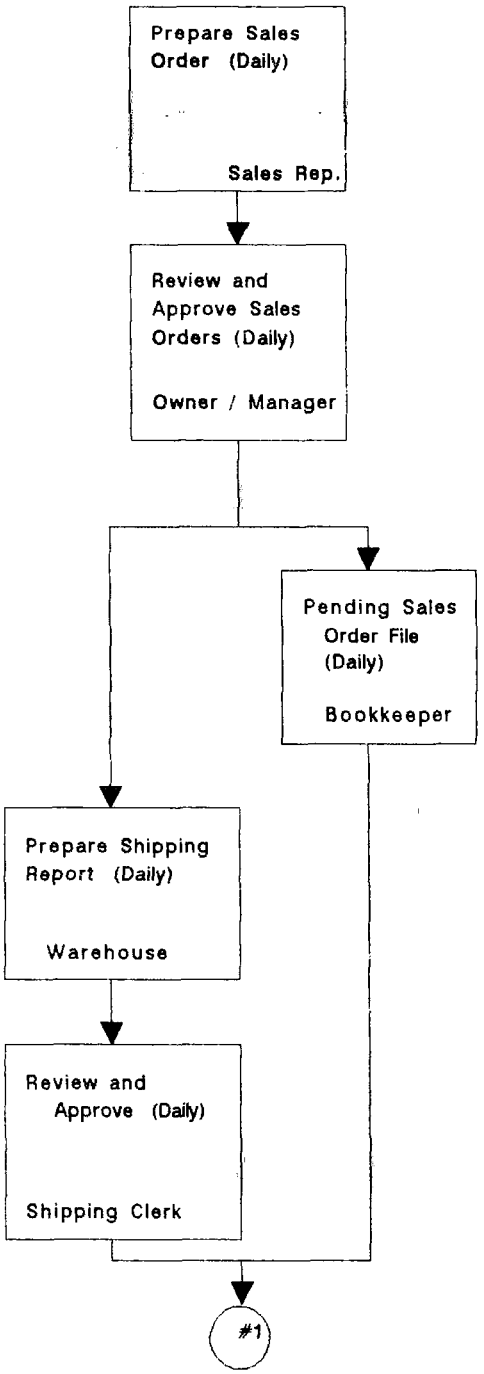
Ed Jones made the decision to purchase a microcomputer and a "turnkey" accounting software package. The source code is not available for this software. Access to the computer and computer files is limited to Willis, Ross, and Jones, who effectively have access to all computer files.

The owner-manager carefully reviews computer-generated financial reports such as reports on receivable aging, and compares revenues and expenses with prior years' performance. He also monitors the terms of the long-term debt agreement that requires certain ratios and compensating balances.

Jones and Willis readily consult with our firm on routine accounting questions. The client does not pay significant attention to accounting estimates (tax accrual, inventory obsolescence, or bad debts). Such estimates are prepared by our firm from information provided by Jones and Willis. Our firm also assists in compiling the financial statements.

OWNCO, INC.
SALES

Originally Completed by: *mlw*
Date: *9/30/x5*
Reviewed By: *jp*
Date: *11/02/x5*



At the time a sale is made, the Sales Rep. enters information such as customer name & number, shipping & inventory description, stock number, and price on a four-part prenumbered Sales Order form. Written explanations of price variances are attached.

The Owner / Manager (Mr. Jones) reviews each Sales Order, for proper price, approves the extension of credit to the customer, and signs the Sales Order (S.O.). Copy #1 is sent to the bookkeeper. Additional copies are sent to the warehouse, the salesman, and the customer. Mr. Jones reviews sales orders after the fact on return from being away.

Bookkeeper receives approved Sales Order #1 from Owner / Manager and files them numerically, pending receipt of shipping report.

Upon receipt of S.O. #2, the Warehouse Supervisor ensures that the Owner / Manager has signed the Sales Order and then has the Warehouse pull the goods and prepare the Shipping Report.

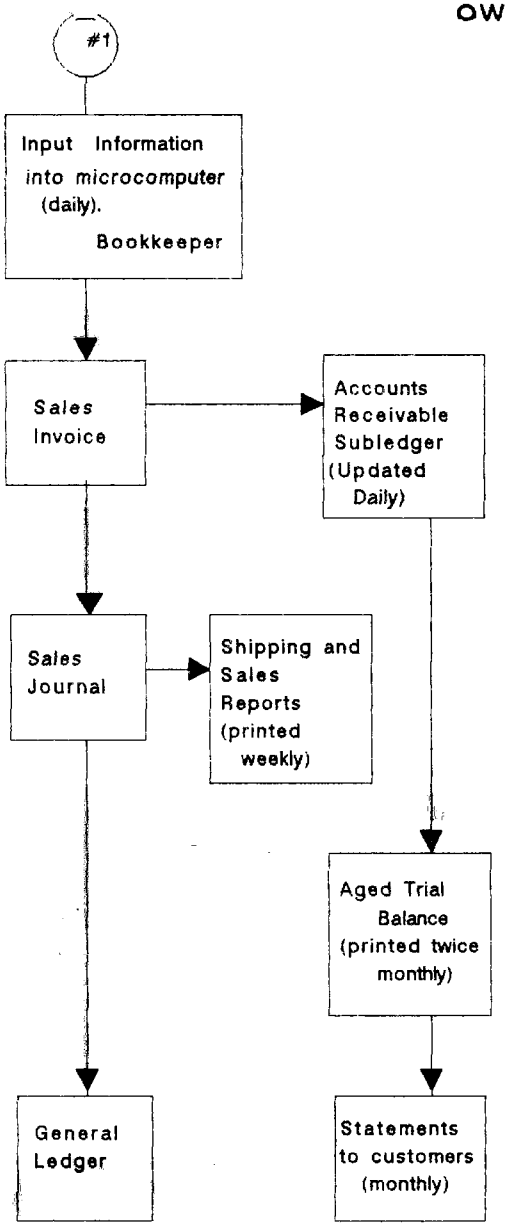
The Shipping Clerk receives the Shipping Report, S.O. #2 and the pulled goods from the warehouse. The Shipping Clerk verifies that the goods agree with the Sales Order and the Shipping Report, initials the Shipping Report, prepares the goods for shipment, and ships the goods.

The shipping report goes to the bookkeeper to be matched with the sales order. Copies also go to the customer, and to the shipping supervisor (for filing in the shipping dept.).

OWNCO, INC.
SALES

EXHIBIT B–2
(continued)

OWNCO, INC.
SALES



The bookkeeper enters stock number , quantity, prices and customer information into the microcomputer.

The computer prints sales invoices, and updates the cumulative sales and accounts receivable master files daily. The bookkeeper matches computer generated invoices with sales orders and shipping reports for completeness. The bookkeeper also investigates unmatched sales orders and shipping reports monthly. The original sales invoice (including a breakaway remittance advice) is sent to the customer. The matched sales order, shipping report, and sales invoice are stapled together and filed by sales invoice number.

At the end of the day a procedure is run to post transactions to the cumulative sales file, the accounts receivable master file, and the general ledger.

The Owner/Manager reviews sales reports and shipping reports weekly.

The Owner / Manager reviews the aged trial balance twice monthly, and follows up on past due accounts. The Owner / Manager pays particular attention to accounts over 30 days past due.

Statements are mailed to customers monthly. The statement asks for disputed balances to be discussed with Mr. Jones, the owner/manager.

The bookkeeper reconciles the accounts receivable subsidary ledger with the general ledger monthly.

Updated by: *mw* Date: *9/15/x6* Reviewed by: *jp* Date: *10/29/x6*

Updated by: Date: Reviewed by: Date:

EXHIBIT B-3

WP INDEX *PERM. FILE ICS-3*

OWNCO, INC.

UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE

Completed by:	*mlw*	Date:	*9/30/X5*	Reviewed by:	*jp*	Date:	*11/02/X5*
Updated by:	*mlw*	Date:	*9/15/X6*	Reviewed by:	*jp*	Date:	*10/29/X6*
Updated by:		Date:		Reviewed by:		Date:	
Updated by:		Date:		Reviewed by:		Date:	
Updated by:		Date:		Reviewed by:		Date:	

UNDERSTANDING OF CASH RECEIPTS

Checks and remittance advises are received by Chris Ross, Mr. Jones' (the owner-manager's) secretary. A complete listing of all checks received is prepared by Ross. The original list is retained, and a copy is given to Pat Willis (the bookkeeper) along with the checks and remittance advises.

Willis prepares the bank deposit and adds the account code to the items listed. The deposit is then delivered to the bank and a copy of the deposit slip, receipted by the bank, is returned to Ross.

Ross compares the deposit slip with the original list of checks.

Willis inputs customer and cash receipts information into the microcomputer. Willis runs routine to update account receivable master file and cash receipts file daily. Transactions are posted to the general ledger at the same time. The cash receipts journal, subledgers, and general ledger are printed on demand.

Willis compares the computer-generated accounts receivable subsidiary ledgers with the general ledger control account monthly. Willis also prepares the bank reconciliation monthly which is reviewed by Mr. Jones.

RETURNS, ADJUSTMENTS, AND CREDITS

All returns, adjustments, and credits are approved by Mr. Jones. Such transactions are not entered into the computer by Willis without his approval. A report of such transactions is printed monthly and is reviewed by Jones.

EXHIBIT B-4

WP INDEX *PERM. FILE ICS-4*

Completed by: *mlw*
Date: *9/15/x6*
Reviewed by: *jp*
Date: *10/29/x6*

OWNCO, INC.

UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE

REVENUE AND CASH RECEIPTS
SUMMARY OF POTENTIAL RISKS OF MATERIAL MISSTATEMENTS

Summarized below are matters noted while obtaining an understanding of the revenue and cash receipts classes of transactions that may affect the risk of material misstatement.

- *Sales and cash receipts should be posted to the respective journals daily. However, no checks exist to assure that all transactions are posted to the journals and the general ledger.*
- *In addition to the owner-manager, the bookkeeper and the owner-manager's secretary have access to all computer files.*
- *There is no review of adjustments made to accounting records through journal entries, except indirectly through review of monthly financial statements.*
- *As noted on ICS-1, accounting estimates are not adjusted except at year end.*

NOTE: The audit program (not illustrated here) adequately addresses these issues.

**UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE
AND
CONTROL RISK ASSESSMENT**

CLIENT *Ownco, Inc.* BALANCE SHEET DATE *12/31/x8*

Completed by: *mlw* Date: *9/15/x6* Reviewed by: *jp* Date: *10/29/x6*

We obtained sufficient knowledge of the design of the control environment, the accounting system and control procedures to plan the audit, and determined that they have been placed in operation.

Workpapers related to our understanding of the internal control structure are included at *Perm. Files ICS-1 through ICS-13.* [Only Perm. Files ICS-1 through ICS-4 are illustrated in exhibits B-1 to B-4.]

Except as noted below, and on the reference workpapers, we have assessed control risk to be at the maximum and have designed our substantive audit procedures accordingly.

For those significant assertions related to the account balances indicated below, we have assessed control risk at less than the maximum and the effects of such assessment have been reflected in our audit program. For assertions for each account balance or class of transactions where control risk has been assessed at less than the maximum, tests of controls (this may include either knowledge of operating effectiveness learned while obtaining the understanding of the internal control structure or more extensive tests of controls to support the assessed level) have been performed to provide evidential matter sufficient to evaluate the effectiveness of the policies and procedures relevant to the various assertions.

CASH **WORKPAPER REF** _____

ACCOUNTS RECEIVABLE **WORKPAPER REF** C-2 [Illustrated at Exhibit B-6]
Control risk is assessed as slightly below the maximum for the following assertions: existence, rights and obligations (ownership), and valuation (other than the net realizable value objective for which control risk is assessed at the maximum). Control risk for completeness is assessed as moderate. Accordingly, primary audit evidence for existence, ownership and valuation (except net realizable value) will be obtained by year-end confirmation of all key items (over $5,000), a nonstatistical representative sample of 5% of the remaining population (see workpaper C-5 for basis of sample size not illustrated here), and cutoff tests at year-end. Evidence about the net realizable value objective will be obtained by procedures set forth in the audit program, which consider: subsequent cash collections, the aged trial balance, analytical procedures, and review of specific accounts with the owner-manager.

Audit evidence for completeness will be obtained by application of (1) year-end cutoff tests and (2) analytical procedures applied to sales (comparison of the prior year's sales and gross profits to the current year's sales and gross profits on a month-by-month basis, together with discussions with the owner-manager and inspection of corroborating evidence for unexpected fluctuations).

INVENTORY **WORKPAPER REF** *D-5* [Not Illustrated Here]
Prior experience and tests of controls indicate that the client has good controls over physical counts and pricing of material items in inventory. These tests of controls support a moderate control risk assessment.

FIXED ASSETS **WORKPAPER REF** _____

OTHER ASSETS **WORKPAPER REF** _____

ACCOUNTS PAYABLE **WORKPAPER REF** *N-3* [Not Illustrated Here]
Prior experience and tests of effectiveness of control structure policies and procedures over accruals and payables support a moderate assessed level of control risk. It is most efficient to test payables by reviewing all subsequent cash disbursements over $3,500.

ACCRUED LIABILITIES **WORKPAPER REF** _____

NOTES PAYABLE AND LONG-TERM DEBT **WORKPAPER REF** _____

OTHER LIABILITIES **WORKPAPER REF** _____

SHAREHOLDERS' EQUITY **WORKPAPER REF** _____

REVENUE ACCOUNTS **WORKPAPER REF** *X-8* [Not Illustrated Here]

Our tests of controls support that effective control structure policies and procedures have been placed in operation during the year by the owner-manager primarily to review the reasonableness of recorded sales. A moderate control risk assessment for completeness, existence and valuation assertions supports an audit strategy of using analytical procedures as the primary substantive test (along with tests of receivables) for revenue accounts.

EXPENSE ACCOUNTS **WORKPAPER REF** *X-10* [Not Illustrated Here]

Our tests of controls support that effective control structure policies and procedures have been placed in operation during the year by the owner-manager to review the reasonableness of expense accounts. A moderate control risk assessment for existence and valuation assertions supports an audit strategy of using analytical procedures as the substantive test for many expense accounts. The primary test of completeness of expenses will be the search for unrecorded liabilities and the review of subsequent cash disbursements.

CLIENT *Ownco, Inc.* BALANCE SHEET DATE *12/31/x6*

Completed by: *mlw* Date: *9/15/x6* Reviewed by: *jp* Date: *10/29/x6*

TESTS OF CONTROLS
RELEVANT TO ACCOUNTS RECEIVABLE

I have reviewed the permanent file documentation of the understanding of the internal control structure (ICS) on W/P ICS-1,2,3, & 4. While confirming this understanding I performed the following procedures which provided some evidence of the operating effectiveness of ICS policies and procedures relevant to the audit of accounts receivable.

Overall control environment issues. During the period 9/11/x6 to 9/15/x6 I made inquiries of Mr. Jones regarding operating performance for the year compared with prior years, new investments and financing activities during the year. He continues to demonstrate a conservative attitude toward business risks and the company appears to have maintained a significant cushion beyond working capital, dividend, and compensating balance requirements of debt agreements. There has been no turnover of personnel working directly with the accounting system. Based on inquiries of Jones and Willis and examining computer reports during the review of the accounting system, the company continues to use the same computer software as in prior years, and no modifications have been made to the company's computer system.

Owner-Manager internal control structure policies and procedures. During the period 9/11/x6 to 9/15/x6 inquiries were made of Mr. Jones regarding the extent of his procedures to approve credit and sales, and review the sales and shipping reports, and the accounts receivable aged trial balance. In addition, inquiries were made of Pat Willis regarding the extensiveness of the owner-manager review of computer reports. Mr. Jones' follow-up on older accounts was evident from his discussion of the accounts and corroborating inquiries of Willis and Ross indicate that receivables are followed carefully by Jones. I also examined evidence of Jones' follow-up procedures by way of notations on aged trial balances and in correspondence with customers. Mr. Jones also indicated that based on his approval of sales orders and subsequent review of receivables, omissions, existence, or pricing errors of significant amounts were unlikely. Pat Willis indicated that on occasion Mr. Jones questioned receivable balances and the pricing of sales included in such balances. Because of this owner-manager involvement, large errors in quantities and prices are unlikely.

Accounting system and relevant control procedures. Inquiries were made of Jones and Willis about the nature of the company's sales and cash receipt transactions and the ownership of receivables. Selected transactions (see W/P XX-2; not illustrated here) were traced through the accounting system to confirm the understanding of the system and significant control procedures and to confirm our understanding that the company owns its receivables. No errors were noted in the pricing, classification, or the time period in which the transactions were recorded (several transactions were chosen near month end). On 9/12/x6 I reviewed the open files for sales orders, shipping reports and follow-up procedures with Pat Willis. Unmatched sales orders were not over four days old, with the exception of one special order that both Willis and Jones were aware of and had not been shipped. There were no unmatched shipping documents. Based on inquiry of Mr. Jones, Pat Willis appears to follow up on unmatched sales orders and shipping reports at the end of the month, and randomly throughout the month, as time allows. Several bank reconciliations were examined for unusual items, and one reconciliation was tested (see W/P XX-3; not illustrated here).

Based on the above tests of controls, involving inquiry of several individuals, observation of personnel in the performance of their duties, and examination of evidence supporting the review of reports by management, the proper recording of transactions, and follow-up and reconciliation procedures performed by Willis -- control risk is assessed as indicated below for the following assertions or audit objectives (otherwise control risk is assessed at the maximum):

- *Completeness of recorded sales and receivables -- moderate.*
- *Existence of recorded sales and receivables -- slightly below the maximum.*
- *Valuation of individual receivables at their gross amount -- slightly below the maximum.*
- *Rights and obligations -- low, not a significant assertion.*

On 2/1/X7 I made inquiries of Jones and Willis about changes in the procedures discussed above. Both indicated that no changes had been made, which is consistent with prior experience. In addition, several transactions for the period 9/13/X6 to 12/31/X6 were traced through the system, and procedures were performed to test year-end cutoff and bank reconciliations. The above interim control risk assessments appear to be appropriate for the entire year under audit.

2/18/X7 MLW

UNDERSTANDING OF THE CONTROL ENVIRONMENT

CLIENT *Young Fashions, Inc.* BALANCE SHEET DATE *09/30/x6*

Completed by: *SDM* Date: *5/10/x5* Reviewed by: *DGW* Date: *5/28/x5*

An understanding of the control environment should be obtained on all engagements. The control environment reflects the overall attitude, awareness, and actions of the board of directors, management, owners, and others concerning the importance of control and its effect on establishing, enhancing, or mitigating the effectiveness of specific control policies and procedures. The control environment includes such factors as:

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees -- particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance -- including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

The following form may be used to document the auditor's understanding of the control environment. In considering the various control environment factors, attention should be focused on management's overall attitude, awareness, and actions -- rather than on specific items related to a control environment factor.

MANAGEMENT PHILOSOPHY AND OPERATING STYLE

POINTS TO CONSIDER:

- o Dominance by one or a few individuals.
- o Management's attitude toward and monitoring of business risks.
- o Management's financial reporting philosophy.
- o Management's willingness to consult with its auditors on accounting issues and adjust the financial statements for likely misstatements.
- o Management responsiveness to prior recommendations.
- o Management priority given to the internal control structure.
- o Control environment over accounting estimates.

RELEVANT CONTROL ENVIRONMENT FEATURES:

The company is a young company (10 years old) and key management decisions are made by a few officers (see organizational structure). The company is primarily concerned with the business pressures associated with operations and earnings growth. Management readily accepts adjustments on clear-cut issues but is known to aggressively challenge proposed adjustments involving accounting estimates. There are no formal controls over accounting estimates and bonus arrangements (viewed as a key to increasing sales and earnings), which may provide some bias to overstate earnings. Management has made some changes to the internal control structure based on auditor recommendations, but management's priorities are in other areas.

ORGANIZATIONAL STRUCTURE

POINTS TO CONSIDER:

- o Briefly describe the entity's organizational structure (attach organizational chart if it is available).
- o Clarity of lines of authority and responsibility.
- o Level where policies and procedures are established.
- o Adherence to such policies and procedures.

- o Adequacy of supervision and monitoring of decentralized operations.
- o Appropriateness of organization structure for size and complexity of the entity.

RELEVANT CONTROL ENVIRONMENT FEATURES:

The company is in the apparel business. Company headquarters are in California and manufacturing locations are in California, Texas, and South Carolina. Significant operating and financial decisions are centralized in company headquarters. Key decisions rest with an active management team of the CEO (and majority shareholder), COO, CFO, and Sales Manager. Virtually all operating decisions relative to data processing (DP) have been delegated to the DP Manager. Divisional management reports to the COO and divisional sales and profits are carefully monitored by the key management team.

BOARD OF DIRECTORS AND ITS AUDIT COMMITTEE

POINTS TO CONSIDER:

- o Describe the board of directors and audit committee.
- o Existence of written charter for audit committee.
- o Communication between the board, audit committee, and external and internal auditors.
- o Is audit committee an informed, vigilant, and effective overseer of the financial reporting process and the company's internal control structure?
- o Regularity of meetings and qualification of members of audit committee.

RELEVANT CONTROL ENVIRONMENT FEATURES:

The board of directors consists of seven members, four officers of the company, a non-officer shareholder, and two outside directors (a lawyer and a banker). The company has not formed an audit committee.

METHODS OF ASSIGNING AUTHORITY AND RESPONSIBILITY

POINTS TO CONSIDER:

- o Policies regarding acceptable business practice.
- o Clear assignment of responsibility and delegation of authority.
- o Communication of employee job responsibilities, duties, and constraints (including written job descriptions).

RELEVANT CONTROL ENVIRONMENT FEATURES:

Delegation of authority and responsibility is informal. Key officers actively supervise business operations with the exception of data processing. Business decisions impacting data processing are the responsibility of the DP Manager. Divisional management participates with key officers in making business decisions, but authority rests largely at the top. There are few written policies regarding acceptable business practices. A written policy does exist on investments by key company personnel in vendors and suppliers. Other policies are informal and discussed in employee orientation.

MANAGEMENT CONTROL METHODS

POINTS TO CONSIDER:

- o Board of directors' review of entity performance.
- o Adequate management control of business and accounting activities.
- o Clear budget, profit, and other financial and operating objectives.
- o Active communication and monitoring of such objectives.
- o Active planning and reporting systems that monitor and communicate to management variances from planned performance.

RELEVANT CONTROL ENVIRONMENT FEATURES:

The board of directors compares performance with projected results on a quarterly basis. Budgets are set informally by key officers (rather than by more formal methods involving middle management). Top management reviews actual results against budget monthly for each division. While variations from budgets are reviewed on a regular basis, management does not extensively document their follow-up procedures.

INTERNAL AUDIT FUNCTION

POINTS TO CONSIDER:

- o Existence of internal audit function.
- o Effect of internal audit on the risk of material misstatement in the financial statements.
- o Independence of internal audit function.
- o Documentation of planning, work performed, and conclusions in audit programs, workpapers, and reports.
- o Management attention to the recommendations of internal audit.

RELEVANT CONTROL ENVIRONMENT FEATURES:

The Company does not have an internal audit function.

PERSONNEL POLICIES AND PROCEDURES

POINTS TO CONSIDER:

- o Background, experience and competence of personnel.
- o Personnel turnover.
- o Personnel training.
- o Employee workload.
- o Resources necessary to discharge assigned duties.

RELEVANT CONTROL ENVIRONMENT FEATURES:

The CFO has only been on the job for 18 months. There is some ongoing employee turnover due to low wages. In the current year, employee turnover in the Texas manufacturing location has been higher than normal for personnel that work in inventory and shipping, and input significant information into the computerized accounting system. In addition, some workload problems exist during peak seasons (Dec.-Jan. and June-July). All personnel policies and hiring practices for the DP department are the responsibility of the DP Manager, who tries to hire personnel with significant DP experience rather than training entry-level personnel.

EXTERNAL INFLUENCES

POINTS TO CONSIDER:

- Monitoring and compliance requirements imposed by legislative or regulatory bodies, or by others outside the entity (such as an active review of bank loan agreements).

RELEVANT CONTROL ENVIRONMENT FEATURES:

The bank loan officer meets regularly with young fashion's management to monitor the company's financial performance, which heightens management's consciousness about taking and monitoring business risks.

****
THIS SECTION INTEGRATES A NUMBER OF CONTROL ENVIRONMENT FACTORS THAT MAY AFFECT RELATED COMPUTER DATA PROCESSING. NEITHER SAS NO. 55 NOR FIGURE 2-6 PRESENTS COMPUTER DATA PROCESSING AS A SEPARATE CONTROL ENVIRONMENT FACTOR. FACTORS AFFECTING COMPUTER DATA PROCESSING HAVE BEEN COMBINED BELOW FOR PRESENTATION PURPOSES. HOWEVER, IT MIGHT BE MORE APPROPRIATE TO CONSIDER SUCH FACTORS WHEN CONSIDERING RELEVANT CONTROL ENVIRONMENT ELEMENTS (AS HAS BEEN ILLUSTRATED IN CHAPTER 2).
****

COMPUTER PROCESSING

POINTS TO CONSIDER:

Management Philosophy and Operating Style

- Management's attitude toward its investments, risks, and benefits of data processing.

Organizational Structure

- Is data processing centralized or decentralized? Briefly describe organization of data processing.
- Supervision and monitoring of data processing by senior management.
- Communication between management of accounting and data processing departments.

Methods of Assigning Authority and Responsibility

- Management communication of scope of authority and responsibility to data processing management.
- Documentation of data processing policies and procedures.

Management Control Methods

- Management monitoring of above policies and procedures.
- Management's attitude, awareness, and actions regarding:
  - Approving changes in systems and control policies and procedures.
  - Safeguarding programs and files.
  - Access to or destruction of documents, records, or assets.
- Review of computer activities by internal audit.

Personnel Policies and Procedures

- Policies and procedures for hiring, training, evaluating, promoting, and compensating employees, and giving them the resources necessary to discharge their assigned responsibilities.

RELEVANT CONTROL ENVIRONMENT FEATURES:

Data processing (DP) is centralized in head office. DP operates an IBM System 36 with telecommunications links from divisional locations (15 terminals at head office and 8 at divisional locations). Data from remote locations is processed in batches rather than on an online basis. The Company uses primarily purchased software. Most of the purchased software is three to five years old and, based upon the Company's rapid growth and diversification, is now somewhat limited in being able to keep pace with the Company's functional business requirements. Vendor documentation is maintained, but DP management admits that documentation of changes could be better. Likewise, the hardware environment / technical environment is nearing its capacity.

Senior management does not appear to be sensitive to the functional and technical limits of data processing, but nonetheless expects data processing to effectively serve the Company's business needs and be accurate. Management has delegated authority and responsibility to the DP Manager and is not actively involved in setting or monitoring policies, although the CFO and other management personnel do review DP output, primarily for the purpose of controlling operations. While a formal DP security policy does not exist, the DP Manager has performed an assessment of sensitive programs and data files to determine whether access restrictions are appropriate. The Company generally uses vendor authorized consultants to make system changes, although the DP manager has made simple system changes.

Briefly discuss the significant elements of the internal control environment that affect the risk of material misstatement in the financial statements.

MAJOR CONCERNS:

1. *The control environment is reflective of the Company's recent growth. Many control methods features, such as budgetary control or the delegation of responsibility for data processing, are informal and rely on monitoring by management at appropriate levels.*
2. *Management incentives create an environment with a moderate bias to overstate earnings.*
3. *Turnover of personnel responsible for input of shipping and billing information at the Texas division is likely to increase the risk of routine processing errors. This problem was acute during peak seasons.*

****

NOTE: SOME OF THE MATTERS NOTED IN THIS QUESTIONNAIRE COULD BE CONSIDERED TO BE "REPORTABLE CONDITIONS." THIS EXAMPLE IS INTENDED TO ILLUSTRATE POSSIBLE DOCUMENTATION OF THE UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE AND IS NOT INTENDED TO ILLUSTRATE REPORTING OF SUCH CONDITIONS.

****

CLIENT *Young Fashions, Inc.* BALANCE SHEET DATE *09/30/X5*

Completed by: *SDM* Date: *5/12/X5* Reviewed by: *DGW* Date: *5/28/X5*

Understanding of Class of Transactions: Sales

1. How is the transaction initiated?

Nationwide sales force writes sales orders that are approved by credit manager in head office.

Changes to master-price files occur as necessary to move inventory. The sales manager reviews and approves authorized changes to the master-price file by regularly reviewing a "was-is" report on price changes. Personnel in sales manager's office are responsible for updating master-price file.

Sales returns and allowances are not significant as the company's policy is to sell goods without the right of return, except under specific circumstances.

2. Describe the source documents that support the transactions.

Sales Orders	*- Manually written and approved (see above).*
	- Copy filed in accounting with sales invoice.
Bill of Lading	*- Manually written in shipping department.*
	- Copy filed in shipping.
Packing Slip	*- Prepared by computer; information describing items and quantities shipped is input over terminal at each shipping location.*
	- Copy filed in accounting with sales invoice.

Note: Information from the sales order and the bill of lading is input into the computer through a remote terminal at divisional offices.

3. Describe the machine-readable information that is used in the processing of accounting information.

Master-Price File
Outstanding Transaction File
Cumulative Sales File
Accounts Receivable Master File
General Ledger Master File

4. Describe the documents and reports generated by the accounting system.

Sales Invoice - The invoice is generated by the computer (see processing below).
- Invoices are scanned by accounts receivable employees before filing with packing slip and sales order.
Outstanding Orders Report - Prepared daily.
Unmatched Document Report - List unmatched sales orders, bills of lading, packing slips, and sales invoices: prepared weekly and at month end.
Changes in Master-Price File - Run when changes are made. Filed in Sales Manager's Office (see discussion on page 1 of 2).
Sales Journal - Filed monthly.
Accounts Receivable Aged Trial Balance - Prepared weekly, month end reports are kept on hand.
Monthly Statements to Customers - No hard copies retained by the company.
Weekly Sales Summary by Customer and by Inventory Product Number - Copies are kept by sales manager.
General Ledger - Filed monthly.

5. Describe the accounting processing, records and files (including how frequently they are updated), and other machine-readable information that is used to process the transaction, including how transactions are reflected in journals of original entry and the general ledger.

Information on sales orders is input by sales department into an outstanding transactions file daily.

Information on goods shipped is input daily to prepare packing slip, sales invoice, and update outstanding transactions file. Transactions are posted daily to the cumulative sales file and accounts receivable master file when sales order, bill of lading, packing slip, and invoice information match.

See above for description of how changes to master-price file are initiated and processed.

6. Describe control procedures understood while obtaining an understanding of the control environment and the accounting system.

- *Once a week, and at month end, an accounts receivable clerk reconciles subsidiary ledgers with the general ledger control account.*

- *The computer generates a list of unmatched sales orders, bills of lading, packing slips, and sales invoices weekly and at month end. A clerk in accounts receivable follows up on items over five days old.*

- *The computer checks the numeric sequences of sales orders, bills of lading, packing slips, and sales invoices.*

- *The DP Manager periodically reviews an access violation report that reports access violations such as DP personnel using utility programs to modify data files or access to A/R master file and A/R G/L transaction file by accounts receivable clerks.*

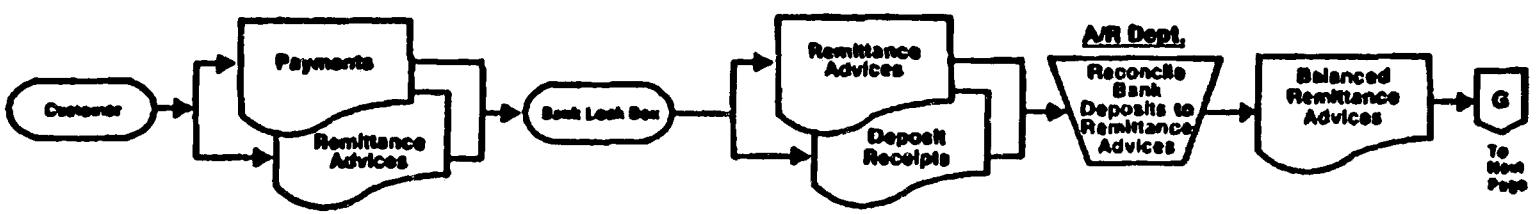
7. Describe other control procedures that are relevant to the audit.

An understanding of additional control procedures is not considered necessary to plan the audit.

Prepared by: SDM
Date: 7/12/x5
Reviewed by: DGW
Date: 8/25/x5

YOUNG FASHIONS, INC.

UNDERSTANDING OF CASH RECEIPTS

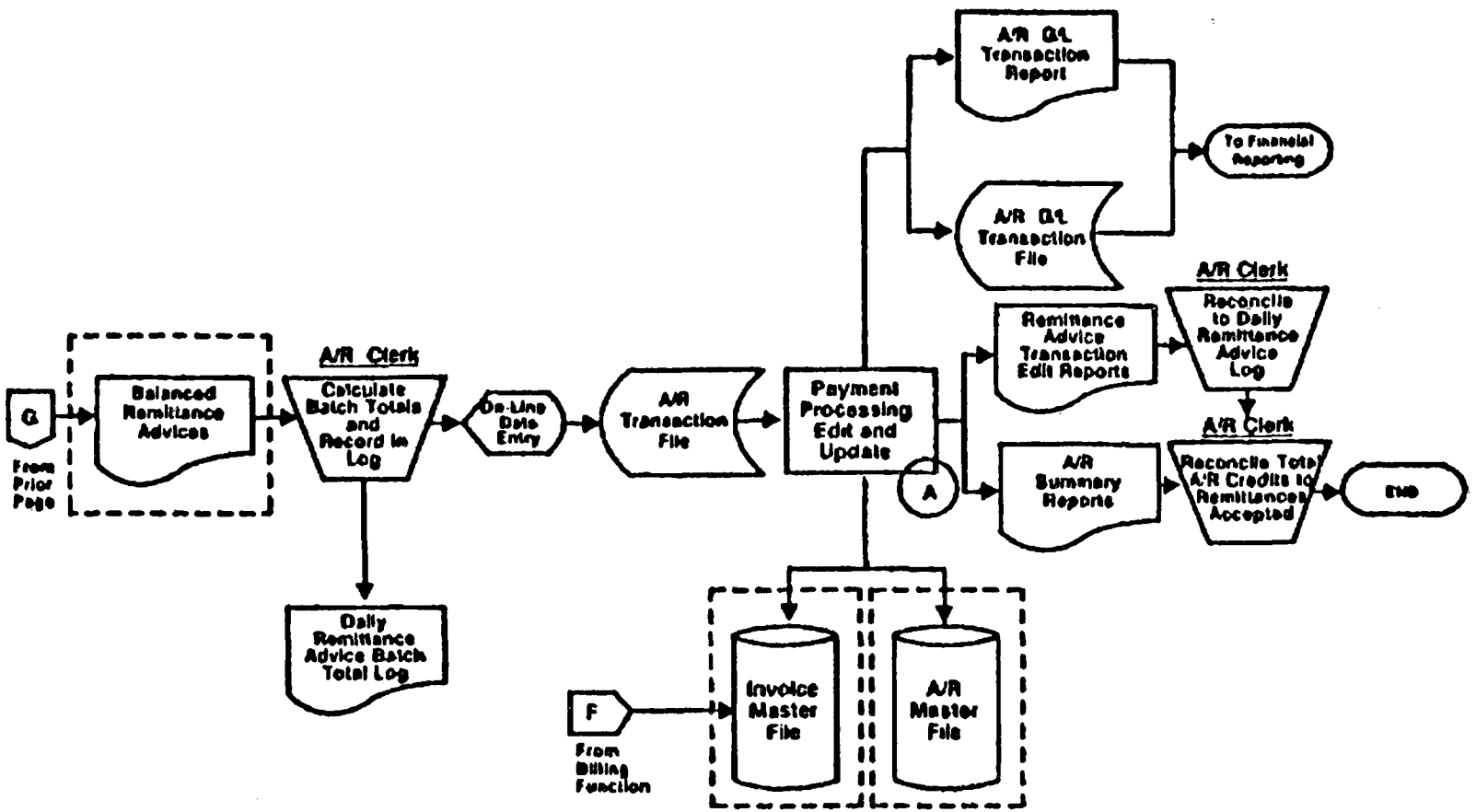


Prepared by: SDM
Date: 7/12/x5
Reviewed by: DGW
Date: 8/25/x5

EXHIBIT C-3
(Continued)
page 2 of 2
WP INDEX *IC-26*

YOUNG FASHIONS, INC.

UNDERSTANDING OF CASH RECEIPTS
(Continued)



(A) Payment Processing Program:
- Edits and validates Remittance Advice records on the A/R Transaction File.
- Updates Invoice Master and A/R Master File records to reflect payments.
- Produces edit reports of accepted and rejected Remittance Advice transaction records.

NOTE: Independent bank reconcilations are performed by an accountant working under the CFO.

SUMMARY OF CONTROL RISK ASSESSMENT

CLIENT *Young Fashions, Inc.* BALANCE SHEET DATE *09/30/X5*

Completed by: *SDM* Date: *5/19/X5* Reviewed by: *DGW* Date: *5/28/X5*

Control risk assessment relevant to: Sales / Accounts Receivable

Instructions: In the space provided below, address the relevant internal control structure policies and procedures and the related tests of controls (this may include either knowledge of operating effectiveness learned while obtaining the understanding of the internal control structure or additional tests of controls) for assertions where control risk is assessed at less than the maximum.

Existence and Occurrence:

The accounting system requires that a sales invoice be matched with sales order, bill of lading, and packing slip information before the cumulative sales file and accounts receivable master file are updated. No invoices were noted without a supporting sales order, bill of lading, or packing slip during my examination of selected reports of unmatched documents. Based on discussions with accounts receivable personnel on 5/11/X5 and with selected shipping personnel at Texas and California locations on 4/18/X5 and 5/8/X5, respectively, invoices are not processed until all supporting information is available. In addition, selected sales transactions (see W/P XX-4-1; not illustrated here*) were traced through the system and all transactions represented valid sales.*

Inquiries of the accounts receivable clerks on 5/13/X5 indicated that these clerks could access both the A/R master file and the A/R G/L transaction file, and because of their access to the main menu at logon, they could modify specific records which would not be detected by the monthly reconciliation of the subsidiary ledgers to the general ledger. However, our substantive audit procedures will include a review of all nonstandard general ledger transactions to determine the propriety of any unusual entries. These clerks are also responsible for the review of the DP output from the accounts receivable system.

Based on this examination of evidential matter, combined with the results of extended inquiry of several individuals, and corroborating observations, control risk is assessed as slightly below the maximum.

Completeness:

Client internal control structure policies and procedures relevant to completeness relate primarily to the computer listing of unmatched sales orders, bills of lading, packing slips, and sales invoices. Based on discussions with accounts receivable personnel on 5/11/X5 and with selected shipping personnel at Texas and California locations on 4/18/X5 and 5/8/X5, respectively, it normally can take up to two weeks between the placing of a sales order and shipment. It is rare, however, for an unmatched bill of lading or packing slip to remain on the unmatched documents report for more than two days. This was corroborated by examining the unmatched documents report for selected days (see W/P XX-4-2; not illustrated here*) where the longest period a bill of lading or packing slip was outstanding was two days. Selected transactions on these reports were traced to underlying documents with no exceptions.*

Based on this examination of evidential matter, combined with the results of inquiry of accounts receivable and shipping personnel, and corroborating observations, control risk is assessed as slightly below the maximum.

Rights and Obligations:

Control risk is assessed at the maximum.

Valuation and Allocation:

Gross Valuation of Receivables and Sales

Internal control structure policies and procedures include good user department controls in sales over changes to the master-price files. Inquiries of the sales manager and employees in the sales manager's office on 5/11/X5, and examination of selected "was-is" computer reports of master-price file changes (see W/P XX-4-3; not illustrated here*) indicate that this aspect of valuing gross receivables is carefully reviewed. Supporting documentation for selected price changes was also examined and no exceptions were noted.*

Invoice quantities, however, are not subject to the same control procedures. Past history indicates that immaterial quantity errors do occur during heavy seasonal periods. This history appears not to have changed based upon review of correspondence with customers and responses to inquiries of accounts receivable personnel. However, no such errors were noted in the current period that approached amounts equivalent to tolerable misstatement. Also, a greater concern exists relative to receivables involving the Texas operation because of high turnover of personnel.

Based on the above tests of controls, control risk is assessed as slightly below the maximum except the Texas operation, where control risk is assessed at the maximum.

Valuation and Allocation (cont.):

Net Valuation of Receivables

Control risk is assessed at the maximum.

Presentation and Disclosure:

Control risk is assessed at the maximum.

On 10/15/X5 inquiries about changes in the internal control structure were made of the CFO, the DP Manager, and accounts receivable personnel. No significant changes were made to the systems affecting the existence and occurrence and completeness assertions, and objective of gross valuation of sales and receivables. The gross valuation objective, however, was affected by changes in key accounting personnel. These inquiries were corroborated by inquiries made on 10/18/X5 of personnel at the California manufacturing location, by observations of employees in the performance of their duties, and by examining selected transactions at the Texas location[1] for the period 5/1/X5 to 9/30/X5. Based on these tests, the above control risk assessments appear to be valid for the entire year.

SDM 10/21/X5
DGW 11/20/X5

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1 See W/P XX-4-4 (not illustrated here) for results of examining selected transactions. This selection was increased over planned tests that assumed no turnover in accounting personnel.

VINCO, INC.

DOCUMENTATION OF THE UNDERSTANDING OF THE INTERNAL CONTROL STRUCTURE

The following examples of documentation of the understanding of the internal control structure for Vinco, Inc. would be included in the working papers. These illustrations indicate the types of work papers that might be prepared. Certain work papers are listed or referred to that are not included to indicate that related documentation would exist. Readers should assume that this documentation shows that an effective internal control structure has been designed and placed in operation. Other methods of documenting the understanding are appropriate and the examples are not intended to be exclusive of other methods.

Exhibit No.	WP Index	Exhibit Title
D-2	C-10	Control Environment Questionnaire
D-3	R-10	Summary of Revenue Cycle Documentation (illustrated on page 1 of 7)
	R-20	Documentation of the Order Entry Function (not illustrated in this exhibit)
	R-30	Documentation of the Shipping Function (not illustrated in this exhibit)
	R-40	Documentation of the Billing Function (illustrated on pages 2 through 6 of 7)
	R-50	Documentation of the Cash Receipts Function (not illustrated in this exhibit)
	R-60	Documentation of the Collection Efforts Function (illustrated on page 7 of 7)
D-4	G-10	Documentation of Computer General Control Procedures Questionnaire
D-5	Various	Summary of Additional Tests of Controls (see separate index at exhibit D-5)
D-6	R-1 to R-4	Summary of Risk Assessments and Audit Approach for Assertions Relating to Receivables and Revenues
D-7	R-5	Update of Risk Assessments for Receivables and Revenues

CONTROL ENVIRONMENT QUESTIONNAIRE

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12/31/X8*

Completed by: *RS* Date: *9-11-X4* Reviewed by: _____ Date: *10-4-X4*

Completed by: _____ Date: _____ Reviewed by: _____ Date: _____

Completed by: _____ Date: _____ Reviewed by: _____ Date: _____

MANAGEMENT PHILOSOPHY AND OPERATING STYLE

Management's philosophy and operating style have a significant influence on the control environment -- particularly when management is dominated by one or a few individuals. Management's philosophy and operating style should create a positive atmosphere in which the risk of misstatements is reduced, and that is conducive to the effective operation of the accounting system and control procedures.

	YES, NO, NA	COMMENTS
Are management and operating decisions dominated by one or a few individuals?	*NO*	
Does management adequately consider the potential effects of taking large or unusual business risks prior to doing so?	*YES*	*Management is conservative in taking business risks and in selecting accounting policies.*
Are business risks adequately monitored?	*YES*	
Management's financial reporting philosophy is best characterized as (circle one): Maximize Income Smooth Earning Growth Minimize Taxable Income Other _____		*While there is some pressure from shareholders to improve earnings and dividends, this has not yet impacted management's position on accounting issues.*
Is management willing to adjust the financial statements for misstatements that approach a material amount?	*YES*	

	YES, NO, NA	COMMENTS
Does management adequately consult with its auditors on accounting issues?	*YES*	*We meet regularly with management to discuss accounting and auditing issues, and there have been no disagreements over audit adjustments or internal control recommendations.*
Has management been responsive to prior recommendations from its auditors?	*YES*	
Is a high priority given to internal control structure?	*YES*	
Has management established adequate control policies and procedures over acccounting estimates?	*NO*	*Management has not established such controls to cause us to modify a heavily substantive approach.*
Has management established a control environment that minimizes biases that may affect accounting estimates?	*YES*	

ORGANIZATIONAL STRUCTURE

An entity's organizational structure provides the overall framework for planning, directing, and controlling operations. As organizational structures vary, an entity's control structure policies and procedures should also vary to fit the needs and circumstances.

Briefly describe the type of entity and its organizational structure (obtain an organization chart if it is available). *See Organization Chart at C-11.*

Senior management maintains a high degree of centralized control. Operating policies are determined centrally by senior management. General managers supervise local operations.

	YES, NO, NA	COMMENTS
Entity		
Is the organization of the entity clearly defined in terms of lines of authority and responsibility?	*YES*	
Are policies and procedures for authorization of transactions established at an adequately high level?	*YES*	*Senior management group*
Are such policies and procedures adequately adhered to?	*YES*	
Is there adequate supervision and monitoring of decentralized operations?	*YES*	*V.P. Operations works closely with general managers.*
Is the organizational structure appropriate for the size and complexity of the entity?	*YES*	
Accounting and Data Processing		
Is management actively involved in supervision of data processing?	*YES*	*V.P. Administration, Controller and D.P. Manager regularly discuss current issues and problems. V.P. Administration is concerned about adequate general control procedures and reliability of reports and information from D.P.*
Is there sufficient communication between management of the accounting and data processing departments?	*YES*	
Are accounting and data processing centralized or decentralized?		*Centralized*
Is there sufficient supervision and monitoring of decentralized operations?	*NA*	

BOARD OF DIRECTORS AND AUDIT COMMITTEE

The audit committee (or an equivalent function on the board of directors) should take an active role in overseeing the entity's accounting and financial reporting policies and procedures.

	YES, NO, NA	COMMENTS
Are there regular meetings of the board of directors (or comparable bodies) to set policies and objectives, review the entity's performance, and take appropriate action, and are minutes of such meetings prepared and signed on a timely basis (Copies of minutes at WP PF-10)? (Not illustrated)	*YES*	
Does an audit committee exist?	*YES*	*Consists of three independent board members.*
Does the audit committee represent an informed, vigilant, and effective overseer of the financial reporting process and the company's internal controls?	*YES*	
Has the board of directors written a charter for the audit committee, outlining its duties and responsibilities?	*NO*	*Responsibilities are communicated informally.*
Does the audit committee adequately assist the board in maintaining a direct line of communication with the entity's external and internal auditors?	*YES*	*Meets twice a year with us to review scope and results of our work. Meets twice with internal auditors.*
Does the audit committee have adequate resources and authority to discharge their responsibilities?	*YES*	
Is this evidenced by:		
o Regular meetings held?	*YES*	*Three times a year.*
o The appointment of qualified members?	*YES*	
o Minutes of meetings?	*YES*	*(Copies of minutes at WP PF-12--not illustrated.)*

METHODS OF ASSIGNING AUTHORITY AND RESPONSIBILITY

The methods of assigning authority and responsibility should result in clear understanding of reporting relationships and responsibilities established within the entity.

	YES, NO, NA	COMMENTS
Entity		
Have appropriate entity policies regarding such matters as acceptable business practices, conflicts of interest, and codes of conduct been established and are they adequately communicated? (Briefly describe the extent of such policies and practices.)	*YES*	*See workpaper C-50 (not illustrated) for conflicts-of-interest policy.*
Is there a clear assignment of responsibility and delegation of authority to deal with such matters as organization goals and objectives, operating functions, and regulatory requirements?	*YES*	
Are employee job responsibilities, including specific duties, reporting relationships, and constraints clearly established and communicated to employees?	*YES*	*While there is only partial documentation of employee job descriptions, responsibilities are clarified through regular contact.*
Data Processing		
Has management clearly communicated the scope of authority and responsibility to data processing management?	*YES*	*Senior management meets regularly with DP management to monitor operating problems, current system projects, and future needs.*
Is there adequate computer systems documentation indicating the procedures for authorizing transactions and approving systems changes?	*YES*	
Is there adequate documentation of data processing policies and procedures?	*YES*	

MANAGEMENT CONTROL METHODS

Management control methods affect management's direct control over the exercise of authority delegated to others and its ability to effectively supervise overall company activities. Management should establish appropriate control methods (considering the authority delegated to others) in order to (1) supervise company activities and performance, (2) detect indicators of possible misstatements, and (3) monitor and approve changes to accounting systems and control procedures.

	YES, NO, NA	COMMENTS
Does management have clear objectives in terms of budget, profit, and other financial and operating goals?	*YES*	*The budgeting system is well developed, including follow-up activities. See workpaper C-30 for review of significant budget variations and discussions with management.*
Are such objectives:		
o Clearly written?	*YES*	
o Actively communicated throughout the entity?	*YES*	
o Actively monitored?	*YES*	
Has the entity established planning and reporting systems that set forth management's plans and the results of actual performance (list systems relevant to planning the audit)?	*YES*	
Do the planning and reporting systems in place:		
o Adequately identify variances from planned performance?	*YES*	
o Adequately communicate variances to the appropriate level of management?	*YES*	
Does the appropriate level of management:		
o Adequately investigate variances?	*YES*	
o Take appropriate and timely corrective action?	*YES*	

	YES, NO, NA	COMMENTS
Has management established procedures to prevent unauthorized access to, or destruction of, documents, records, and assets?	*YES*	
Data Processing		
Has management established policies for developing and modifying accounting systems and control procedures?	*YES*	*The company has established standards for development of accounting systems and control procedures and their documentation.*
Has management established policies for controlling access to programs and data files?	*YES*	
Does management adequately monitor such *policies?*	*YES*	*Management regularly reviews compliance with these standards, including internal review audit (see G-10).*

INTERNAL AUDIT FUNCTION

The internal audit function should provide an independent and effective mechanism to examine and evaluate the adequacy and effectiveness of other internal control structure policies and procedures.

	YES, NO, NA	COMMENTS
Does the entity have an internal audit function?	*YES*	
Does the work of the internal auditor reduce the risk of material misstatement in the financial statements (or does it focus primarily on operational auditing?)	*YES*	*See workpaper C-40 for review of internal audit workpapers.*

	YES, NO, NA	COMMENTS
Is the internal audit function independent of the activities they audit?	*YES*	*I.A. Manager reports to president and meets regularly with the audit committee.*
Does the internal audit function report to the audit committee or other independent body?	*YES*	*Twice annually.*
Is the internal audit function adequately staffed in terms of the number of employees and their training and experience?	*YES*	
Do internal auditors document the planning and execution of their work by such means as audit programs and workpapers?	*YES*	*I.A. audits a wide range of financial and operating areas.*
Do internal auditors render written reports on their findings and conclusions?	*YES*	*They have good standards for documenting and reporting the results of their work.*
Does management take adequate and timely actions to correct conditions reported by the internal audit function?	*YES*	

PERSONNEL POLICIES AND PRACTICES

The entity's personnel policies and practices should have a positive influence on the entity's ability to employ sufficiently competent personnel to accomplish its goals and objectives. In considering the effect of personnel policies and procedures on the audit, they may affect the organization as a whole, or particular aspects of the organization (e.g., data processing) or accounting systems (e.g., payroll vs. purchases and acquisitions). Where appropriate, identify accounts or transactions cycles that may be specifically impacted by personnel issues -- such as high turnover of personnel.

	YES, NO, NA	COMMENTS
Do client personnel appear to have the background and experience for their duties?	*YES*	

	YES, NO, NA	COMMENTS
Do client personnel understand the duties and procedures applicable to their jobs?	*YES*	
Is the turnover of accounting personnel relatively low?	*YES*	*Normal turnover.*
Does the entity provide for adequate training of new personnel?	*YES*	*Mostly through close supervision where needed.*
Does the workload of the client personnel appear to permit them to be mindful of controlling the quality of their work?	*YES*	*Heavy management workloads are normal, but not a problem.*
Does previous experience with the client indicate sufficient competence on the part of client personnel?	*YES*	*There is generally a high level of experience, training, and qualifications of company personnel.*
Does previous experience with the client indicate sufficient integrity on the part of client personnel?	*YES*	
Has management provided employees with the resources necessary to discharge their assigned duties?	*YES*	

EXTERNAL INFLUENCES

To be considered an effective factor in an entity's control environment, parties outside an entity should exert sufficient influence to heighten management's consciousness of, and attitude towards, the conduct and reporting of an entity's operations, or prompt management to establish specific internal control structure policies and procedures.

	YES, NO, NA	COMMENTS
Is the entity subject to monitoring and compliance requirements imposed by legislative and regulatory bodies?	*NO*	*There are no external influences that have a significant effect on the company's internal control structure.*
Do other parties outside the entity actively review and follow-up the entity's actions (such as an active review of bank loan agreements)?	*NO*	

SUMMARY OF SIGNIFICANT POLICIES AND PROCEDURES AND EFFECT ON AUDIT STRATEGY

Briefly discuss the significant elements of the internal control environment that affect the risk of material misstatement in the financial statements.

The control environment reflects an excellent atmosphere conducive to the effective operation of the accounting system and control procedures. There are strong direct control methods, including responsibility reporting and internal audits.

Thus, the risk of material misstatement is reduced throughout the financial statements. The audit strategy will not, as a result, require extensive testing at all locations, and some work can be performed prior to the balance sheet date.

SUMMARY OF TESTS OF CONTROLS

Briefly summarize the tests of controls (if any) performed to test the operating effectiveness of the significant policies and procedures.

The understanding of the control environment was based on prior experience with the entity, regular meetings, with management since the last audit, and observation and inquiry of management during audit planning (9-8-X4 to 9-11-X4).

The influence of management's philosophy and operating style, the audit committee, methods of assigning authority and responsibility, and a positive attitude toward control consciousness were tested through regular meetings in the current year to discuss accounting issues (see Workpaper C-8 [not illustrated]*).*

Other procedures that influenced this overall assessment of an effective control environment include:	
Tests of management's review of budget variations	*C-30*
Tests of internal audit	*C-40*

UNDERSTANDING OF ACCOUNTING SYSTEMS AND CONTROL PROCEDURES

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Completed by: *Roger Smith* Date: *9-13-X4*

Reviewed by: *Paul Harmon* Date: *10-1-X4*

The detailed questionnaires included in this practice aid were designed for use by the auditor in obtaining an understanding of control procedures necessary to support a control risk assessment significantly below the maximum.

IDENTIFY CYCLES (AND THE RELATED FUNCTIONS) FOR WHICH A CONTROL RISK ASSESSMENT SIGNIFICANTLY BELOW THE MAXIMUM IS DESIRED:

Revenue Cycle (Includes Receivables, Revenues); this cycle includes the following functions: order entry, shipping, billing, cash receipts, and collection efforts.

IDENTIFY RELATED ASSERTIONS FOR WHICH A CONTROL RISK ASSESSMENT SIGNIFICANTLY BELOW THE MAXIMUM IS DESIRED:

Existence, occurrence, completeness, and the objective that receivables are stated at their gross value (relates to the valuation assertion). For the realizable value objective of the valuation assertion, the planned control risk assessment is moderate (see documentation at R-60 and R-40).

FOR EACH FUNCTION COMPLETE THE APPROPRIATE DOCUMENTATION:

Order entry - see R-20	[not illustrated in this exhibit]
Shipping - see R-30	[not illustrated in this exhibit]
Billing - see R-40	[illustrated on pages 2 through 6]
Cash receipts - see R-50	[not illustrated in this exhibit]
Collection efforts - see R-60	[illustrated on page 7]

VINCO, INC.

ACCOUNTING SYSTEM - BILLING FUNCTION

CONTROL PROCEDURES QUESTIONNAIRE

BILLING FUNCTION

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Completed by: *Roger Smith* Date: *9-13-X4*

Reviewed by: *Paul Harmon* Date: *10-1-X4*

Objective:

All shipments made should be billed and recorded in the general ledger and subsidiary records.

	YES, NO, NA	COMMENTS
Are prenumbered shipping documents used and is the sequence accounted for?	*YES*	*(a)*
Are control totals of shipments made reconciled with totals of sales invoices processed?	*YES*	*(b)*
Are input validation controls used?	*YES*	*(c)*
Are sales invoices matched with shipping documents (or based on a file of shipments made)?	*YES*	*(d)*
Are control totals of sales invoices processed reconciled with sales amounts posted to the accounts receivable master file?	*YES*	*(e)*
Are control totals of sales invoices processed reconciled with sales amounts posted to the general ledger?	*YES*	*(f)*
Is the receivables account in the general ledger reconciled with the accounts receivable master file on a regular basis?	*YES*	*(g)*

(a) The Order Entry Program issues sequentially numbered bills of lading for each day's scheduled shipments based on the Daily Priced-Out Sales Order File. The sequence is subsequently accounted for -- see (b) for details.

(b) Upon receiving bill of lading packages from the warehouses, the accounting clerk uses an adding machine to prepare batch totals of quantities shipped. She then enters on the terminal the batch totals and data from the individual bills of lading. The Billing Program prepares its own batch totals from the individual bills of lading and produces a report listing any differences from the totals entered by the accounting clerk. The Billing Program also checks the numeric sequence of bills of lading and reports any breaks in the sequence. Differences are investigated by a second clerk and resolved before further processing.

(c) The Billing Program includes programmed application control procedures such as (1) completeness controls to ascertain that bill of lading input fields (such as customer number and quantity shipped) contain data, (2) check digits to ascertain that customer and product numbers are valid, and (3) numeric and range controls to determine that customer number, product number and quantity shipped fields contain only numeric characters that are within prescribed ranges. Input that violates any of these controls results in an error message and must be corrected before further processing.

(d) The Billing Program prepares the Daily Shipments File based on shipping data input by the accounting clerk. The program compares the Daily Shipments File with the Daily Priced-Out Sales Order File and produces a report listing differences between quantities actually shipped and quantities scheduled for shipment. Differences are investigated by the accounting clerk, and corrections are entered on the terminal. The Billing Program then produces invoices and the Daily Sales File.

(e) The A/R Update Program processes the Daily Sales File and the Daily Cash Receipts File to update the A/R Master File. The program takes daily sales and cash receipts totals and uses these to reconcile the accounts receivable subledger balance with the prior day's balance.

(f) The Sales Accumulation Program processes the Daily Sales File to update the MTD Sales File. At month end, the G/L Program processes the MTD Sales File to update the accounts in the General Ledger File. Each day, the program reconciles the total added to the MTD Sales File with the daily sales invoice listing.

(g) An accounts receivable clerk reconciles the A/R Master File with the G/L control accounts monthly.

CONTROL PROCEDURES QUESTIONNAIRE

BILLING FUNCTION

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Completed by: *Roger Smith* Date: *9-13-X4*

Reviewed by: *Paul Harmon* Date: *10-1-X4*

Objective:

Billings should be based on shipments made, should be accurately computed, and should be accurately and promptly summarized and recorded in the correct accounts in the general ledger and subsidiary records.

	YES, NO, NA	COMMENTS
Are quantities billed compared with shipping documentation?	*YES*	*(a)*
Are control totals of shipments made reconciled with totals of sales invoices processed?	*YES*	*(b)*
Are invoices calculated using an approved price list or master-price file?	*YES*	*(c)*
Is the mathematical accuracy of invoice calculations periodically rechecked?	*NO*	*(d)*
Is the mathematical accuracy of report totals periodically rechecked?	*NO*	*(e)*

(a) The Billing Program prepares the Daily Shipments File based on shipping data input by the accounting clerk. The program compares the Daily Shipments File with the Daily Priced-Out Sales Order File and produces a report listing differences between quantities actually shipped and quantities scheduled for shipment. Differences are investigated by the accounting clerk, and corrections are entered on the terminal. The Billing Program then produces invoices and the Daily Sales File.

(b) Upon receiving bill of lading packages from the warehouses, the accounting clerk uses an adding machine to prepare hash totals of bill of lading numbers and batch totals of quantities shipped. She then enters on the terminal the hash and batch amount of the individual bills of lading. The Billing Program prepares its own hash and batch totals from the individual bills of lading and produces a report listing any differences from the totals entered by the accounting clerk. Differences are investigated by a second clerk and resolved before further processing.

(c) Invoice amounts are calculated by the Order Entry Program (see R-20) using the approved master-price file. A computer label (machine-readable) is used to provide assurance that the correct master-price file is used.

(d) The entity relies on the Order Entry Program for accuracy of invoice calculations and does not recheck calculations.

(e) The entity relies on the Billing Program and other programs to produce accurate report totals and does not recheck these totals.

CONTROL PROCEDURES QUESTIONNAIRE

COLLECTION EFFORTS FUNCTION

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Completed by: *Roger Smith* Date: *9-13-X4*

Reviewed by: *Paul Harmon* Date: *10-1-X4*

Objective:

Accounts receivable should be recorded at net realizable value.

	YES, NO, NA	COMMENTS
Does the entity perform adequate follow-up procedures for collection of past-due receivables?	*YES*	*(a)*
Are write-offs approved by management and processed on a timely basis?	*YES*	*(b)*
Does the entity regularly monitor the adequacy of its reserve for uncollectible accounts and establish appropriate provisions?	*YES*	*(c)*

(a) Letters are mailed to the customer at various stages between 30 and 90 days past due. After accounts are 90 days past due, they are turned over to a collection agency (based on region of the country). No further credit is allowed. The Controller maintains regular contact with the collection agencies.

(b) After accounts reach 180 days past due, they are written off, unless collection is imminent (according to collection agency). Write-offs are approved by the Controller.

(c) Each month, management adjusts the reserve after performing an in-depth analysis of past-due accounts and estimates the uncollectible portions based on knowledge of each customer's payment history and financial condition. The company relies on the computer system to produce accurate aging information and performs only a reasonableness review. Each quarter, the formula is adjusted if necessary.

GENERAL COMPUTER CONTROL PROCEDURES QUESTIONNAIRE

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Completed by: *Roger Smith* Date: *9-13-X4*

Reviewed by: *Paul Harmon* Date: *10-1-X4*

"General computer control procedures" are intended to ensure that application systems, including programmed control procedures, operate consistently and properly, and that data and programs are adequately secured.

This questionnaire may be used to document the audit team's understanding of general computer control procedures. It includes two parts:

I. Background information about the computer processing function
II. Understanding of general computer control procedures

I. BACKGROUND INFORMATION

This section may be used to document relevant background information about the computer function to provide a proper perspective for the review of general computer control procedures.

A. HARDWARE AND SYSTEMS SOFTWARE

List the significant hardware and systems, including separate locations (if any):

- IBM 4381-2 computer
- DOS/VS operating system
- IBM 3270 CRTs in each warehouse
- CICS communication
- IBM software (SORT, DITTO, librarian)
- Data bases (receivables, payables, inventory)
- Security software (GASP)
- Librarian software (GULP)

B. APPLICATIONS

List the major computer-based application systems:

- Revenue cycle, including cash receipts and inventory update (on-line, batch update)
- Payroll (batch)
- Payables/Disbursements, including inventory update (on-line, batch update)

C. COMPUTER ORGANIZATION AND MANAGEMENT

Consider the organization and management of the computer function using the following questions.

	YES, NO, NA
Does the person responsible for the day-to-day activities (e.g., the systems manager) report to a sufficiently high level in the organization to heighten the visibility of computer processing from a management perspective?	*YES*
Is the computer systems department well structured with defined communication and reporting channels?	*YES*

	YES, NO, NA
Is there a long-range computer systems plan which is based on and supports the strategic business plan?	*YES*
Does a computer systems steering committee (or some other management group) regularly review computer systems department projects, establish priorities, and monitor progress to ensure that they are in line with the entity's objectives?	*YES*
Are there appropriate personnel policies (i.e., hiring, promotion, retention, vacation, etc.)?	*YES*
Do computer systems personnel have no duties in other departments and have no access to, or responsibility for, the disposition of company assets or the accounting distribution thereof?	*YES*
Is there adequate segregation of duties between operations, system programming, application programming, and data control?	*YES*

NOTE: This listing is not necessarily all-inclusive.

Comments:

See organization chart G-10. See minutes of computer systems steering committee at G-20 [not illustrated in this exhibit].

SUMMARY OF PART I

There are several significant applications with complex processing (e.g., revenue cycle, payables/disbursements cycle) where it may be appropriate to obtain an additional understanding of the accounting system and control procedures. Therefore, it is also appropriate to obtain an understanding of computer general control procedures.

II. GENERAL COMPUTER CONTROL PROCEDURES

This section may be used to document the understanding of general computer control procedures by addressing the following objectives:

A. Application Development

The company should maintain effective control over authorized application development to ensure that new application programs are suitably designed and tested.

B. Application Maintenance

The company should maintain effective control over authorized application and systems maintenance to ensure that modifications to application programs are authorized and are completely and accurately implemented.

C. Access to System Resources

The company should maintain effective control over access to, and use of, system resources (application and system programs, key data and program files, processing time, etc.) to ensure that only authorized program changes are made to the data files supporting the financial statements, and are the result of authorized and accurate application processing.

D. Computer Operations

The company should maintain effective control over computer operations to ensure that only authorized application programs are processed to meet the company's processing needs and that only the proper data files are used during processing.

Space is also included to summarize (1) the most significant policies and procedures and their effect on the audit strategy and (2) the tests of controls (if any) performed (or to be performed) to test the operating effectiveness of these policies and procedures.

A. Application Development

[not illustrated in this exhibit]

B. Application Maintenance

Objective:

The company should maintain effective control over application and systems maintenance to ensure that new application programs and modifications to application programs are completely and accurately implemented.

	YES, NO, NA	COMMENTS
Does the company have documented policies and procedures for modifications to application programs?	*YES*	*(a)*
Does user management determine and/or approve the functional requirements of all program changes?	*YES*	*(b)*
Is program documentation updated for all maintenance performed?	*YES*	
Are modified systems adequately tested to ensure proper operation of programmed procedures?	*YES*	*(c)*
Are the results of maintenance and testing approved by computer systems management and application users before conversion?	*YES*	*(c)*
Is the transfer of programs to production status controlled to ensure that only approved programs are used for processing the company's transactions?	*YES*	*(d)*

(a) The company has a standards manual for all systems development and modification projects.

(b) Written approval is required by the data processing manager and the appropriate user department manager for all program changes.

(c) Appropriate testing is performed for all program changes, and the results are approved by the appropriate department manager.

(d) A General Utility Librarian Package (GULP) and program transfer log are used to control transfer of programs from the production library to the development library at the start of the change process and back to the production library after the change is completed.

C. Access to System Resources

Objective:

The company should maintain effective control over access to, and use of, system resources (application and system programs, key data and program files, processing time, etc.) to ensure that the data files supporting the financial statements are the result of authorized and accurate application processing.

	YES, NO, NA	COMMENTS
Does the company have documented policies and procedures for computer security?	*NO*	*(a)*
Are there adequate physical controls to restrict access to the computer room to authorized individuals?	*YES*	*(b)*
Are programmers restricted from access to production programs?	*YES*	*(c)*
Is there terminal access control software that restricts who can access the system, what programs they can use, and what files the user and/or program can access?	*YES*	*(d)*
Does terminal access control rely on passwords or other identification/validation process to control access to the system?	*YES*	*(d)*
Are passwords administered to ensure that they are confidential, unique, and updated to reflect needed changes on a timely basis?	*YES*	*(e)*
Are all significant events (security violations, use of critical software, or system commands, etc.) logged and promptly investigated by appropriate management personnel?	*YES*	*(f)*

(a) The company does not have a written security policy. However, strong security measures have been established. See below.

(b) Physical access to the computer room is restricted by a combination lock on the door. Visitors sign a log and are accompanied by authorized personnel.

(c) Programmers are segregated from the computer room and a General Utility Librarian Package (GULP) restricts access to production programs and a Global Access Security Package (GASP) restricts access to GULP and data files.

(d) The company uses a Global Access Security Package (GASP) to restrict access to the system to personnel and programs with valid passwords. Each password in turn allows access to selected programs only, based on the user profile. Data files can only be accessed with access to the related production program. The access control package provides further protection of unattended terminals by logging off the terminal after ten minutes of inactivity.

(e) A policy statement issued by the security manager precludes terminal users from distributing their passwords to others, taping the password on their terminal, or leaving their terminal without logging off. All new user passwords and changes are approved by the security manager.

(f) Attempts to access the system, programs, or data files by unauthorized persons are logged by GASP. These logs are sent to the security manager who performs an appropriate investigation.

D. Computer Operations

[not illustrated in this exhibit]

SUMMARY OF SIGNIFICANT POLICIES AND PROCEDURES AND EFFECT ON AUDIT STRATEGY

Briefly discuss the most significant policies and procedures and (a) their impact on the effectiveness of application controls and (b) their effect on audit strategy:

There are strong controls over program development and changes and over access to programs and data. These controls provide reasonable assurance that application systems operate consistently and properly. Therefore, the audit strategy is one of testing general control procedures and related application control procedures to obtain a low control risk assessment.

VINCO, INC.

DATA PROCESSING ORGANIZATION CHART

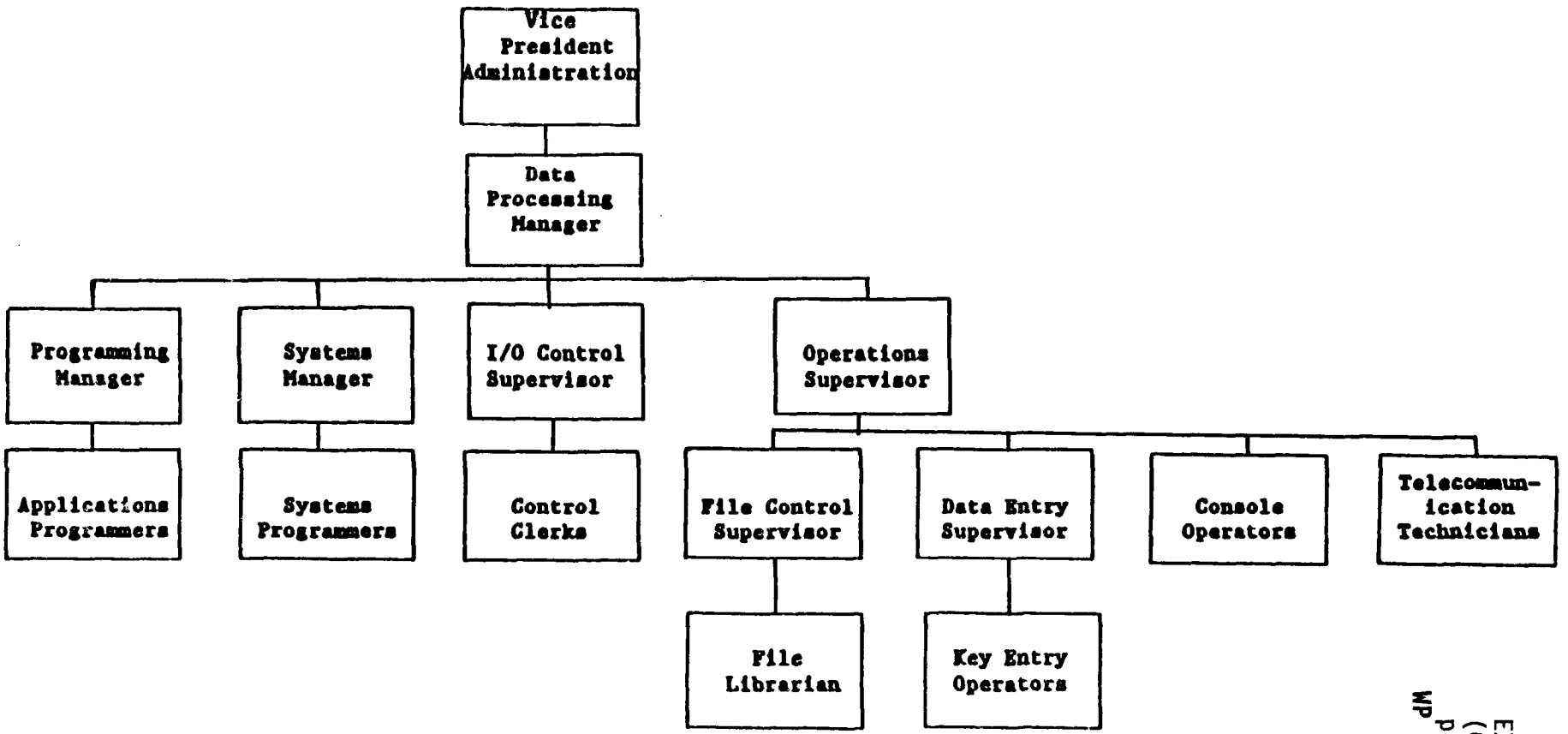

EXHIBIT D-4
(Continued)
page 8 of 8
WP INDEX G-10

VINCO, INC.

SUMMARY OF ADDITIONAL TESTS OF CONTROLS

The following are examples of documentation of tests of controls for Vinco, which would be included in the working papers. These tests are in addition to the procedures performed to obtain the understanding, which also provide evidence of operating effectiveness, and thus would be considered tests of controls (see documentation at C-10, G-10, and R-20 through R-60.)

The following examples of documentation of the tests of controls for Vinco, Inc. would be included in the working papers. These illustrations indicate the types of working papers that might be prepared. Certain working papers are listed or referred to that are not included to indicate that related documentation would exist. Readers should assume that those working papers show that tests of controls on those working papers disclose no exceptions. Other methods of documenting tests of controls are appropriate and the examples are not intended to be exclusive of other methods.

WP Index

C-30 Discussion of significant budget variations with management [illustrated on page 2 of 12]

C-40 Review of internal audit work [illustrated on page 3 of 12]

Tests of accounting system and control procedures for order entry and shipping functions:

R-70 -- Coopersburg warehouse
R-80 -- Los Angeles warehouse
R-90 -- Dallas warehouse
[not illustrated in this exhibit]

R-100 Tests of accounting system and control procedures for billing function [illustrated on page 4 of 12]

R-110 Tests of accounting system and control procedures for cash receipts function [not illustrated in this exhibit]

G-30 Tests of controls over systems development and modifications [illustrated on pages 6 through 8 of 12]

G-40 Tests of controls over computer access control procedures [illustrated on pages 9 through 12 of 12]

VINCO, INC.

DISCUSSION OF SIGNIFICANT BUDGET VARIATIONS WITH MANAGEMENT

Completed by: *Roger Smith*
Date: *9-19-X4*
Reviewed by: *Paul Harmon*
Date: *10-1-X4*

In performing the procedures to obtain the understanding of the entity's budgetary procedures (see C-10) [illustrated in exhibit D-2], *some evidence of operating effectiveness was obtained. The following tests of controls were performed to obtain further evidence about operating effectiveness.*

On September 12, I met with the Controller to discuss the company's procedures for reporting and investigating variations from budget. See C-31 for a copy of the company procedures manual dealing with this matter [not illustrated in this exhibit]. *The key procedures are as follows: The general ledger system produces monthly comparisons of budget with actual performance for each operating location and department managers with instructions for explanation of significant or unusual variations. Explanations are due within one week and are used by the Controller to develop a monthly performance report. This performance report is discussed at the monthly management meeting (including senior management, general managers, and department managers) and is updated for revised explanations and follow-up action.*

I obtained the performance reports for two months -- March and May (see C-32 and C-33) [not illustrated in this exhibit]. *Inspected evidence of appropriate identification of significant or unusual variations, and whether complete and satisfactory explanations had been received.*

In addition, on September 14 I met with the general manager of the Chicago division. His explanation of variations to be investigated was consistent with company policy. For the months of March and May, I inspected management's notations and reviewed the appropriateness of follow-up procedures noting that the control procedure appears to be operating effectively.

VINCO, INC.

REVIEW OF INTERNAL AUDIT WORK

Completed by: *Brenda Jones*
Date: *9-19-X4*
Reviewed by: *Paul Harmon*
Date: *10-1-X4*

In reviewing the qualifications of internal auditors, we found that many internal auditors were both members of the I.I.A. and CPAs with significant experience. Several members of the staff came to Vinco with consulting backgrounds and work primarily with computer audit projects. The company also has and (based on inquiry of several individuals) enforces a policy of 40 hours of continuing professional education for its auditors annually. With respect to objectivity, the head of internal audit reports to the V.P. Finance and meets with the audit committee twice annually to discuss the scope and results of internal audit work. Their qualifications and objectivity were considered acceptable in order to use the results of their audit work in planning the nature, timing, and extent of our auditing procedures.

We selected several areas where we will use the results of internal audit work in determining our audit approach. For each area, we examined the working papers for such matters as the scope of work, the use of audit programs, the documentation in the work papers, the conclusions reached, and reporting of the results of the work. In selected areas, we obtained the documentation used by internal audit to test their results. The following are the areas selected for review:

1. *Inventory test counts at several warehouses (see C-41)* [not illustrated in this exhibit].

2. *Audit for compliance with company policies for investment of excess funds (see C-42)* [not illustrated in this exhibit].

3. *Audit of fixed asset additions at several locations (see C-43)* [not illustrated in this exhibit].

4. *Audit of purchasing department for compliance with purchasing policies and procedures (see C-44)* [not illustrated in this exhibit].

Internal audit schedules the areas to be audited on a rotational basis. There were no audits relating to receivables or sales in 19X4 although these had been done in 19X3.

VINCO, INC.

TESTS OF ACCOUNTING SYSTEM AND CONTROL PROCEDURES FOR BILLING FUNCTION

Completed by: *Brenda Jones*
Date: *9-19-X4*
Reviewed by: *Paul Harmon*
Date: *10-1-X4*

On July 12, I met with Colleen Johnson, Accounting Clerk, to discuss control procedures in the billing function. These procedures include:

1.Reconciling control totals of shipments made and processed.

2.Investigating quantity differences between shipments made and shipments scheduled.

Upon receiving bill of lading packages from the warehouses, Colleen prepares batch control totals (on adding machine tapes) and then enters the data on the terminal. The Billing Program produces a report listing the control totals for each batch. A second clerk, Mary Olson, reconciles this report with the adding machine tapes. Differences are rare and generally result from keypunch errors. I reviewed a sample[1] of the reconciliations for selected days during the year to date.

After these differences are reconciled, the Billing Program prepares the Daily Shipments File. The Program also compares this file with the Daily Priced-Out Sales Order File and produces a report listing differences between quantities shipped and quantities scheduled for shipment. Colleen investigates differences on this report. Differences are rare and generally are due to out-of-stock conditions. This was corroborated by inquiries of shipping personnel at the Chicago operations that confirmed that about 95% of the time they were able to completely fill orders. She enters the appropriate corrections on the terminal which results in bringing the Daily Shipments File and Daily Priced-Out Sales Order File into agreement. I reviewed a sample[1] of the reports for several days during the year noting proper resolution of differences.

I also met with the Controller to discuss the procedures for approving changes to the master accounts receivable files. All changes to the master accounts receivable files are supported by source documents. For example, new customers or revised credit limits are supported by documents prepared by the accounting department. New products and revised prices are supported by documentation received from the vice president of operations. The

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1 *See Workpaper R-102* (not illustrated in this exhibit) *for sample selection and results. These samples were selected randomly on the basis of the firm's policy for tests of controls.*

Controller reviews this documentation and approves the changes. After the changes are processed, the Controller receives a "Was-Is" report. He compares this report to the input to determine that all authorized changes were made. I reviewed a sample[1] of the "Was-Is" reports for selected days during the year noting that all changes agreed with the supporting detail.

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1 See footnote on previous page.

VINCO, INC.

TEST OF CONTROLS OVER SYSTEMS DEVELOPMENT AND MODIFICATIONS

Completed by: *Teddy Techo*
Date: *9-11-X4*
Reviewed by: *Lefty Lambert*
Date: *9-20-X4*

AUDIT OBJECTIVE OVER SYSTEMS DEVELOPMENT AND PROGRAM CHANGE:

1. Newly developed programs and modified programs should be authorized, tested, documented, and operated according to user specifications.

PROCEDURES TO TEST OBJECTIVE OVER SYSTEMS DEVELOPMENT AND PROGRAM CHANGE:

The client has a standards manual for all systems development and modifications. No changes have been made to this manual since our last audit.

There were no new applications implemented during the year to date. However, discussions with the data processing manager (Sally Smooth) revealed several significant modifications to the revenue system and the payables/disbursements system programs.

See also W/P G-40 p.3 for tests of controls over access to programs through the general utility librarian package (GULP).

The following procedures were performed to determine the effectiveness of control procedures over program changes:

1. *Discussed with the DP manager that she does, in fact, ensure that there is adherence to the established programming standards. After all new and changed programs are developed, a quality assurance procedure is used whereby the software code written by the programmer is evaluated for consistency with programming standards. Ms. Smooth showed me a copy of the report that she uses to evaluate adherence to the standards.*

2. *Examined the program change logs generated by the general utility librarian package (GULP) to determine what changes were made and by whom. (A sample of program change logs was examined of programs of systems other than revenue and payables/disbursements to ascertain that only changes had been made to those systems mentioned by Ms. Smooth.) The global access security package (GASP) ensures that only programs authorized by Ms. Smooth and subject to the administrative procedures of GULP can be entered into production libraries. Although there are certain privileged users (e.g., systems programmers) who can circumvent GULP and make a production library change, GASP reports all such violations in a special report, which is reviewed daily by Ms. Smooth.*

3. *Made inquiries related to the risk of program changes that could be made to circumvent the administrative controls of GULP. Determined through inquiry that only changes initiated through GULP could be placed in production, with the exception of immediate fixes made in crisis situations, which must be approved by Sally Smooth, and that all changes are logged.*

For selected changes to the programs in the revenue and payables/disbursements systems, I performed the following procedures:

1. *Examined written approvals by the appropriate department manager and the data processing manager for the changes in the revenue system and the payables/disbursements system programs.*

2. *Examined the program maintenance reports and logs of the program development manager to determine if the changes had been assigned and progress reports submitted in accordance with Vinco's standards.*

3. *Reviewed the final revised program documentation to determine if it complied with Vinco's standards.*

4. *Reviewed the acceptance test results to determine if they contained the user department manager's acceptance sign-on as required by Vinco's standards.*

5. *Examined the GULP TRLOG (program transfer log) reports to determine whether appropriate reviews were made regarding source programs transferred from the production library to the development library at the start of the change process and the completed changed source programs transferred to the production library when the changes had been completed.*

6. *Examined the GULP CLOG (compile log) to determine if the required review was performed regarding whether the accepted source programs had been properly compiled and placed in the production library in accordance with Vinco's standards.*

7. Interviewed user managers to determine if they had approved the changes in their system programs, had signed off on final acceptance, and were satisfied with the processing of the accounting data after gthe changes.

All tests of controls indicated that the changes are made in accordance with Vinco's standard policies and procedures, except for two changes considered by Vinco to be minor modifications not susceptible to high risk and therefore, not subjected to normal acceptance testing. I have reviewed these two changes in the programs and concluded that these programs do not have a significant effect on the internal control structure and therefore we have not applied further procedures.

VINCO, INC.

TEST OF CONTROLS OVER COMPUTER ACCESS CONTROL PROCEDURES

Completed by: *Teddy Techo*
Date: *9-11-X4*
Reviewed by: *Lefty Lambert*
Date: *9-20-X4*

AUDIT OBJECTIVE OVER COMPUTER ACCESS:

1. Physical Access: Computer hardware, software, and documentation should be protected from unauthorized personnel.

2. Program Access: Application programs that process accounting data should be protected from unauthorized changes.

3. Execution of Programs: Operating application programs should be available only to personnel with no conflicting duties.

4. Data Access: Accounting data should be processed and changed only by appropriate application programs.

SUMMARY OF WORKPAPERS RELATING TO COMPUTER ACCESS OBJECTIVES:

Objective 1 -- Physical Access: See G-40 p.2

Physical access controls found generally to be good.

Objective 2 -- Program Access: See G-40 p.3

Vinco utilizes a computer librarian package (GULP) licensed by a reputable vendor to maintain control over production and development programs. My tests found that the librarian package was properly installed, integrated with the global access security package (GASP), and maintained by Vinco personnel. Execution of production programs is also subject to GASP as discussed under objective 3.

Objective 3 -- Execution of Programs: See G-40 pp.3-4

Vinco utilizes a global access security package (GASP) licensed by a reputable vendor. My tests found that this package was properly installed and maintained by Vinco personnel.

Objective 4 -- Data Access: See G-40 p.4

Vinco uses procedures to insure that production runs are authorized to process against accounting data and that utilities that access data are secure and utilized only when authorized.

Policies Pervasive to Access Objectives:

Vinco does not have a formalized security policy, but the communication of security policies and procedures provides an acceptable environment given the centralized nature of security administration. I verified via the INSTALLATION command of GASP that Mr. Footlocker is the only individual with "security" privilege, which indicated that all new user IDs and changes to access rules must go through Footlocker. Although Mr. Footlocker has several responsibilities outside of the security area, based upon his knowledge of various users, he appears to have adequate time to devote to his security responsibilities.

Objective 1 -- Physical Access:

On July 10, I toured the data processing department to observe and make inquiries about physical access control. The following points were noted:

1. *Physical access to the computer room is restricted by a combination lock on the door. Visitors sign a log and are accompanied by authorized personnel.*

2. *Programmers are segregated from the computer room and do not have access to production programs or data files.*

3. *There are no dial-in lines.*

4. *A policy statement issued by the security manager precludes terminal users from distributing their passwords to others, taping the password on their terminal, or leaving their terminal without logging off. The GASP system provides further protection of unattended terminals by logging the terminal off after 10 minutes of inactivity (verified by reviewing the most recent GASP "Installation" report). The security manager, Mr. Footlocker, takes disciplinary action as needed.*

Objective 2 -- Program Access:

Administration: I interviewed Vinco's programming manager (Billy Bob Johnson) and established that the general utility librarian package (GULP) that had been in use when we completed last year's audit was still in use with no modifications. The access rules via GASP preclude any production library "write" access to anyone other than the programming manager, except for certain privileged users as discussed on workpaper G-40. He made available the GULP librarian administration reports generated since the beginning of the year. Selected reports were scanned for apparent completeness and appropriate actions.

See also W/P G-30 for tests of controls over changes made to programs in the revenue and payables/disbursements systems and GULP reports examined as part of these changes.

Objective 3 -- Execution of Programs:

Administration: I interviewed Vinco's security manager (Ralph Footlocker) and established that the global access security package (GASP) that had been in use when we completed last year's audit was still in use with no modifications. The revenue, payroll, and disbursements/ accounts payable systems are all subject to the "full implementation" mode of GASP. He reviews all security violations as was evident from the violation logs for the last several days on his desk which all indicated the follow-up action which he had taken on each violation.

User's Privileges: Mr. Footlocker is the only person with GASP authority to change user's profiles. He has no other incompatible duties. Changes in user's privileges are approved in writing by operational department heads. I inspected the User Attribute Reports (UAR) and the Set Attribute Reports (SAR) generated by GASP for the year to date. The written authorizations for 50 changes were traced to the SAR and the UAR, and no exceptions were noted, see W/P G-40-1 [not included as part of this illustration].

In addition, I examined a special run of the GASP administration functions to provide the AUDIT report for the month of July and LISTUSER report for the current date. The AUDIT report, periodically used by Ralph, provides a list of changes to user's profiles. The LISTUSER report provides a list of all users and their privileges. Ralph compared his list to last year's LISTUSER report and all changes of users with the highest privileges were checked. All users with high access privileges seem appropriate to their job functions (see W/P G-40-3) [not included as part of this illustration].

As usual, with our audit of Vinco, we requested user profiles be established for our audit use in the preaudit meeting on 9/8/X4. We have been using our audit IDs and passwords since that time without problems. On 9/10/X4, with the knowledge of Mr. Footlocker, I tried to access programs that were not part of our profile and obtain access with an improper password without success. My unauthorized attempts were properly recorded on the LOGAC report (see below).

Detective Controls: *Mr. Footlocker made available the LOGAC (logged accesses) reports generated by GASP for the most recent weekly period (these machine-readable reports are purged weekly). The LOGAC report is produced once a week and immediately whenever an unauthorized access is attempted. Mr. Footlocker reviews the weekly reports to determine if accesses are appropriate with known user profiles. Unauthorized access reports are investigated immediately. I noted his initials on the weekly reports indicating his review and several notes on some reports noting follow up on unusual accesses. My attempt at unauthorized access on 7/15/X4 was immediately reported to Mr. Footlocker on a special GASP LOGAC report.*

Objective 4 -- Data Access:

I identified 10 datasets which are part of the systems of financial audit interest. We obtained the GASP rulesets for these subsets and determined in each case that only the related production programs could access those datasets with "write" access with some exceptions. I followed up on the exceptions and determined that in each case special access privileges were allowed to resolve production restart problems that could occur during midnight shift processing. In all such cases, special privilege access is logged and reported on the violation reports which are reviewed by Ralph Footlocker and subsequently approved by Sally Smooth.

SUMMARY OF AUDIT APPROACH

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Prepared by: *Roger Smith* Date: *9-15-X4*

Reviewed by: *Paul Harmon* Date: *10-2-X4*

Account(s): *Receivables/Revenues*

Assertion(s): *Existence and Rights (Ownership)*

Summary of Inherent Risk Factors and Inherent Risk Assessment:

- *At the assertion level, the assertion is not affected by contentious accounting issues or complex calculations*
- *No receivables are pledged or factored*
- *Inherent risk is assessed as moderate*

Summary of Relevant Internal Control Structure Policies and Procedures:

- *Strong control environment reduces risk of misstatements throughout financial statements (see C-10)* [illustrated at Exhibit D-2]
- *Strong accounting system and control procedures over customer master file and authorization and recording of sales (see R-20, R-30, R-40)* [R-40 is illustrated at exhibit D-3]

Summary of Tests of Controls:

- *Testing of control environment by inquiry, observation/inspection of selected documentation and reperformance tests (see details at C-10, C-30 and C-40)* [illustrated at exhibits D-2 and D-5]
- *Testing of accounting system and control procedures by inquiry and observation of appropriate company personnel and examination of evidence (see details at R-20, R-30, R-40, R-50, R-70, R-80, R-90, R-100, R-110, G-10, G-30 and G-40)* [R-40 illustrated at exhibit D-3; G-10 illustrated at exhibit D-4; R-100, G-30, G-40 illustrated at Exhibit D-5]

Control Risk Assessment:

- *Low, based on very strong internal control structure factors relating to these assertions*

Summary of Substantive Tests:

- Analytical procedures (with comparisons between years and to budget) including volume sales by product line, average sales price by product line, days sales in receivables

- Confirmation of a small sample (high tolerance for sampling error) of customers' balances selected randomly from the 10/31 A/R trial balance applying a PPS Sample selected on the Firm's sample size determination tables

- Analytical procedure of activity in the "roll forward" period from 10/31 to 12/31

- Limited test of shipping cutoff at year end

SUMMARY OF AUDIT APPROACH **WP INDEX** *R-2*

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Prepared by: *Roger Smith* Date: *9-15-X4*

Reviewed by: *Paul Harmon* Date: *10-2-X4*

Account(s): *Receivables/Revenues*

Assertion(s): *Completeness*

Summary of Inherent Risk Factors and Inherent Risk Assessment:

- *No significant risk factors. Inherent risk is assessed as moderate.*

Summary of Relevant Internal Control Structure Policies and Procedures:

- *Strong control environment reduces risk of misstatements throughout financial statements (see C-10)* [illustrated at exhibit D-2]

- *Strong accounting system and control procedures over initial recording of transactions and ensuring completeness in subsequent processing (see R-20, R-30, R-40)* [R-40 is illustrated at exhibit D-3]

Summary of Tests of Controls:

- *Testing of control environment by inquiry and observation and various other tests (see details at C-10, C-30 and C-40)* [illustrated at exhibits D-2 and D-5]

- *Testing of accounting system and control procedures by inquiry and observation of appropriate company personnel and examination of evidence (see details at R-20, R-30, R-40, R-50, R-70, R-80, R-90, R-100, R-110, G-10, G-30 and G-40)* [R-40 illustrated at exhibit D-3; G-10 illustrated at exhibit D-4; R-100, G-30, G-40 illustrated at exhibit D-5]

Control Risk Assessment:

- *Low, based on very strong internal control structure factors relating to these assertions*

Summary of Substantive Tests:

- *Same procedures as existence and occurrence assertions (see R-1):*
  - *Analytical procedures*
  - *Confirmation of receivables*
  - *Review of "roll forward"*

- *Limited test of shipping cutoff at year end.*

SUMMARY OF AUDIT APPROACH **WP INDEX** *R-3*

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Prepared by: *Roger Smith* Date: *9-15-X4*

Reviewed by: *Paul Harmon* Date: *10-2-X4*

Account(s): *Receivables/Revenues*

Assertion(s): *Valuation (Objective that Receivables Are Properly Recorded at Gross Value)*

Summary of Inherent Risk Factors and Inherent Risk Assessment:

- *Large volume of transactions, however; calculations are not complex*
- *No significant accounting issues*
- *Inherent risk is assessed as moderate*

Summary of Relevant Internal Control Structure Policies and Procedures:

- *Strong control environment reduces risk of misstatements throughout financial statements (see C-10)* [illustrated at exhibit D-2]
- *Strong accounting system and control procedures over customer master file and authorization and recording of sales (see R-20, R-30, R-40)* [R-40 is illustrated at exhibit D-3]

Summary of Tests of Controls:

- *Testing of control environment by inquiry and observation and various other tests (see details at C-10, C-30 and C-40)* [illustrated at exhibits D-2 and D-5]
- *Testing of accounting system and control procedures by inquiry and observation of appropriate company personnel and examination of evidence (see details at R-20, R-30, R-40, R-50, R-70, R-80, R-90, R-100, R-110, G-10, G-30 and G-40)* [R-40 illustrated at exhibit D-3; G-10 illustrated at Exhibit D-4; R-100, G-30, G-40 illustrated at exhibit D-5]

Control Risk Assessment:

- Low, based on very strong internal control structure factors relating to this assertion

Summary of Substantive Tests:

- Same procedures as completeness and existence assertions (see R-1):
  - Analytical procedures
  - Confirmation of Receivables
  - Review of "roll forward"

- Limited testing of shipping cutoff at year end

SUMMARY OF AUDIT APPROACH **WP INDEX** *R-4*

CLIENT *Vinco, Inc.* BALANCE SHEET DATE *12-31-X4*

Prepared by: *Roger Smith* Date: *9-15-X4*

Reviewed by: *Paul Harmon* Date: *10-2-X4*

Account(s): *Receivables/Revenues*

Assertion(s): *Valuation (Objective that Receivables Are Properly Stated at Realizable Value)*

Summary of Inherent Risk Factors and Inherent Risk Assessment:

- *There is a high degree of judgment involved in determining the allowance for doubtful accounts*
- *Average of 2-3 months sales in receivables*
- *Annual write-offs average 3% of sales*
- *Inherent risk is assessed as high*

Summary of Relevant Internal Control Structure Policies and Procedures:

- *Good control procedures to determine reserve (see R-60)* [illustrated at exhibit D-3]. *However, some audit adjustments have historically been made in this area due to its volatile and subjective nature.*

Summary of Tests of Controls:

- *Control procedures to determine reserve are tested using a "dual purpose" testing approach in connection with substantive tests.*

Control Risk Assessment:

- *Moderate risk of errors in the reserve due to its volatile and subjective nature.*

Summary of Substantive Tests:

- *Analytical procedures (comparison of aging statistics and write-offs between years, comparison of reserve to agings).*
- *Discuss with management the reserve requirements needed for past due accounts by customer, product line and region of the country (this is a "dual purpose" test because it provides evidence of the effectiveness of management's reserve estimates).*

EXHIBIT D-7
WP INDEX *R-5*

VINCO, INC.

UPDATE OF RISK ASSESSMENTS FOR RECEIVABLES AND REVENUES

Completed by: *Roger Smith*
Date: *2-13-X5*
Reviewed by: *Paul Harmon*
Date: *2-15-X5*

On February 13, I made inquiries of the Controller, Internal Audit Manager, Data Processing Manager, and the Credit Manager about changes in the business or in the internal control structure that would affect the inherent and control risk assessments for receivables and revenues noted at R-1 through R-4 [see exhibit D-6]. *Specifically, inquiries were made about changes in:*

- *Industry, economic, business or other factors that would affect receivables and revenues.*
- *Control environment factors that would affect receivables and revenues (see C-10)* [exhibit D-2].
- *The accounting system and control procedures for the revenue cycle (see R-10 through R-60)* [exhibit D-3].
- *General computer control procedures that would affect the revenue cycle (see G-10)* [exhibit D-4].

Based on these inquiries, I learned that there were several minor changes to the accounting system and control procedures (appropriate revisions were made to our documentation at R-20 and R-50) [not illustrated]. *However, these changes were adequately controlled throughout the general computer control procedures and do not significantly affect our control risk assessments at R-1 through R-4.*

In addition, the results of our substantive tests for receivables and revenues (including analytical procedures, confirmations, roll forward testing, shipping cutoff testing, and valuation testing) did not disclose any changes in the business or any significant misstatements that would indicate a potential breakdown in the internal control structure policies and procedures considered in making our inherent and control risk assessments.

Based on the above inquiries and other tests, the inherent and control risk assessments noted at R-1 through R-4 [Exhibit D-6] *are still valid at year end and there is no need for (1) further updating of our tests of controls* [see summary at exhibit D-5] *or (2) revisions to our substantive tests.*